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Comment letters on Use of Legal Interpretations As Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Qualifies as a Sale

American Institute of Certified Public Accountants. Auditing Standards Board. FASB 125 Audit Issues Task Force

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The attached comment letters were received for a working draft of an auditing interpretation titled "The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Qualifies as a Sale"

Committee:	Auditing Standards Board
Task Force:	FASB 125 Audit Issues Task Force
Dates Exposed:	November 24, 1997 through December 15, 1997
Technical Manager:	Julie Anne Dilley

Working Draft
Proposed Interpretation of SAS No. 73, *Using the Work of a Specialist*

"The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Qualifies As a Sale"

Comment Letters

1. Larry Roles - Wells Fargo & Co.
2. M. O. Sigal, Jr. - Simpson Thacher & Bartlett
3. Adam W. Glass - Sidley & Austin
4. James S. Gerson - Coopers & Lybrand LLP
5. David N. Thrope - Arthur Andersen LLP
6. Catherine Crowley - The Chase Manhattan Bank
7. John D. Langer - Salomon Smith Barney
8. Paul Saltzman and Patricia E. Brigantic - The Bond Market Association
9. Mark S. Leiman - Bankers Trust Company
10. Thomas D. Wren - MBNA America
11. Paul V. Salfi - American Bankers Association
12. David Sidwell - JP Morgan
13. Susan M. Koski-Grafer - Financial Executives Institute
14. Daniel Goldwasser and Abraham M. Stanger - Committee on Law and Accounting, with participation of the Committee on Business Bankruptcy and the Subcommittee on Structured Financings of the Section of Business Law of the American Bar Association
15. Francis T. McGettigan - General Electric Company
16. Joel A. Friedman - Chevy Chase Bank
17. Price Waterhouse LLP
18. Mark W. Holloway - Securities Industry Association

(1)

Author: MIME:rolesl@wellsfargo.com at INTERNET
Date: 12/4/97 6:22 PM
Priority: Normal
TO: Julie Dilley at AICPA3
Subject: FAS 125 Legal Opinions

Our Legal Department has just supplied me with a copy of an article, "Accounting for Securitizations Under FAS 125: Why Lawyers are Writing About It," from the September 1997 "Banking Law Journal."

I would urge you to make a copy available to the task force considering the proposed auditing guidance, as posted on the AICPA's web site, as the article specifically addresses whether a legal true sale opinion is an accurate yardstick in trying to determine whether "control" has been surrendered by the transferor . These insights may be valuable in reaching a conclusion on the role of this test as well as other aspects of a legal opinion for use in FAS 125

The article is authored by Walter G. McNeill and Daniel J. Mette, both of Weil, Gotshal & Manges (LLP) in New York.

Since the issue is interpreting the law and legal opinions, it would seem appropriate to invite members of the "securitization bar" to participate in any guidance contemplated on such matters.

Larry Roles
Manager of Accounting Policy
Wells Fargo & Co.
415-396-3325

Banking Law J.
Sept. 1997

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law (Title 17 U S. Code).

ACCOUNTING FOR SECURITIZATIONS UNDER FAS 125: WHY LAWYERS ARE WRITING ABOUT IT

Walter G. McNeill and Daniel J. Mette*

The authors point out that, under FAS 125, the issue of whether c treatment is there has be premising a legal standc result in a d

Article not reproduced in Web version

What consti poses? It is a securitization—a whether the trans anomalous result likely to consult securitization wil

With the ad dards No. 125 (FA the standard for transferor or the factor in determi law. But is a true sale at law standard a useful or probative tool in measuring control? Does it lead to greater clarity of determination or to an improved balance sheet presentation? Or would the Financial Accounting Standards Board (FASB) have been better advised to

* The authors are partners in the New York office of Weil, Gotshal & Manges LLP.

[1] A financial asset is a right to receive payment of money. For example, mortgages and other loans, trade receivables, and license franchise fees are all financial assets. However, not all cash flow streams fit within the definition. For example, neither operating leases nor "future receivables" are considered financial assets. Rather, they are governed by FAS 13 and EITF 88-18, respectively. A direct financing lease receivable consists of a financial and a nonfinancial component. The financial component is the future lease receipts plus any residual value guaranteed by a third party; the nonfinancial component consists of any unguaranteed residual value.

(2)

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December 11, 1997

Mr. Stuart Kessler
Chairman
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Proposed SAS73/FASB 125

Dear Mr. Kessler:

I am the Chair of the TriBar Opinion Committee. TriBar has published reports on legal opinions since 1979 and is composed of members of the following bar associations: New York County, New York State, City of New York, Allegheny County (Pittsburgh), Atlanta, Boston, Chicago, Delaware, Ontario and Texas. TriBar's reports are published in the American Bar Association's *Business Lawyer*, including its Report on Opinions in the Bankruptcy Context: Rating Agency, Structured Financing, and Chapter 11 Transactions which is published at 46 *Bus. Law.* 717 (1991). Its newest report on Third Party Closing Opinions, which supersedes its original 1979 report, will be published in the February 1998 edition of the *Business Lawyer*.

I have recently been furnished a copy of the AICPA proposed auditing interpretation of SAS 73 as it relates to FASB 125. I will distribute it to the TriBar members in connection with our January 13, 1998 meeting. Since TriBar and the American Bar Association's Legal Opinion Committee are two of the nationally recognized authorities on legal opinions, I would hope that the AICPA would afford both groups an opportunity to comment on the proposal as it would undoubtedly be beneficial for both the legal and accounting professions to have coordinated standards and practices in the important area of structured financing.

A copy of the TriBar membership is enclosed for your information.

Sincerely,

M. O. Sigal, Jr.

Enclosure

cc: Thomas L. Ambro, Esq.
Chair, ABA Legal Opinion Committee

Maury B. Poscover, Esq.
Chair, ABA Business Law Section

Ms. Julie Anne Dilley
AICPA, Technical Manager (File 2605)

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December 1997

Since 1979 the TriBar Legal Opinion Committee has issued reports on current opinion issues. Originally composed of members of the legal opinion committees of the New York County Lawyers Association, the Association of the Bar of the City of New York and the New York State Bar Association, TriBar now also has representatives of the Boston, Delaware, Chicago, Toronto, Atlanta, Allegheny County (Pittsburgh), and Texas Bar Associations.

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Opinions in the Bankruptcy Context	*46 Bus. Law. 717 (1991)*
The Remedies Opinion	*46 Bus. Law. 959 (1991)*
Use of ABA Legal Opinion Accord in Specialized Financing Transactions	*47 Bus. Law. 1719 (1992)*
U.C.C. Security Interests Opinions	*49 Bus. Law. 359 (1993)*

TriBar's current project is an update of its original 1979 Report, which is expected to be published in the August 1996 edition of the Business Lawyer.

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Endnotes

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December 12, 1997

Julie Anne Dilley
Technical Manager
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Re: Proposed Auditing Interpretation -- Use of Legal Interpretations as Evidential Matter to Support Management's Assertion that a Transfer of Financial Assets Qualifies as a Sale -- Transactions Where Financial Asset Risk is Assumed by Sister Company

Dear Ms. Dilley:

I am a securitization attorney and I am writing to comment on the portions of the above-referenced proposed auditing interpretation (the "Interpretation") that address the required language set forth in item 1.12 of the Interpretation for "true sale" and "substantive consolidation" legal opinions to support management's assertion that transferred financial assets have been put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

As noted in item 1.01, quoting Paragraph 23 of SFAS 125, derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets "would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity" (emphasis added).

In certain transactions where market (interest rate) risk or credit risk of a transferred asset is assumed by an affiliate of the transferor that is not a special-purpose entity, the "true sale" opinion rendered in the transaction depends on the corporate separateness of the transferor and the affiliate being respected. Thus, the true sale opinion may contain a qualification to the effect that the opinion giver "does not express any opinion as to any bankruptcy case in which the transferor is substantively consolidated with any of its affiliates."

An example of this type of transaction would be the purchase of subordinated Class B mortgage pass-through certificates by a sister company of the transferor of mortgage loans to a trust for securitization, until a sufficient quantity of Class B certificates has been amassed to make their sale in pooled form economically feasible. Another example would be the transfer of an asset-backed security to a trust which concurrently enters into a total return swap or modified total return swap with an affiliate of the transferor, in which some or all of the risk of a change in price of the transferred asset is assumed by the affiliate. (In this context, a "total return swap" implies full credit substitution, whereas the "modified total return swap" excuses performance by the swap counterparty if certain credit events occur with respect to the transferred assets.) In either example, it is my understanding that most securitization law firms would agree that, all other things being equal, (1) a "true sale" opinion is appropriate where the affiliate assuming the risk associated with the asset is distinct from, and neither controls nor is controlled by, the transferor, and (2) such opinion might not be appropriate if the transferor were to assume such risk directly (for example, by retaining the subordinated Class B certificates or entering into the total return swap agreement itself).

Item 1.12 of the Interpretation requires that an opinion be obtained that the transferor would not be substantively consolidated with the transferee to permit accounting for a transfer of financial assets as a sale. Some accountants have interpreted the Interpretation to require, in the context of transactions such as those described in the previous paragraph ("assumed risk transactions"), that an opinion be obtained that the transferor would not be substantively consolidated with any of its affiliates (or, at least, with any affiliate which has assumed risk relating to the transferred asset) in a bankruptcy of the transferor or any such affiliate. This interpretation effectively reads into Paragraph 23 of SFAS 125, after the underlined words in the second paragraph of this letter, the phrase "including in the event that the assets and liabilities of the transferor and its affiliates are substantively consolidated in bankruptcy or receivership."

I cannot comment on the appropriateness of this interpretation as an accounting matter, but I wish to point out a difficulty that it raises in terms of legal opinion practice.

The current practice of securitization law firms in rendering substantive consolidation opinions has been to opine only with respect to the nonconsolidation of a transferor with a transferee which is a bankruptcy remote special purpose entity. These are the opinions that rating agencies have required and that are inarguably contemplated by SFAS 125. The special purpose entity typically has no business other than holding transferred assets for the purpose of securitization. It is subject to tight constraints on its operations and its relationship with the transferor. The purpose of these constraints is to make possible the rendering of a nonconsolidation opinion.

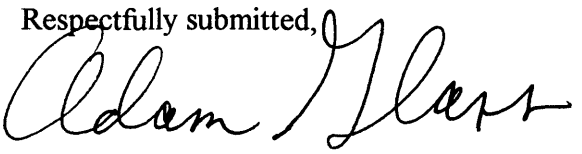
If the Interpretation does in fact require that substantive consolidation opinions be given with respect to the transferor and its operating company affiliates who have assumed some risk associated with the transferred assets by acquiring subordinated interests in the assets or entering into swap agreements with the transferee, then one of two things will happen: law firms will alter their standards on what constitutes a sufficient factual basis to support a nonconsolidation opinion in order to render such opinions, or "assumed risk transactions" of the type described will no longer occur (assuming, as is likely, that sale treatment is essential to the economics of such transactions).

Ending sale treatment of these transactions might be analytically correct within the framework of SFAS 125 if substantive consolidation were the norm when a member of a related group of operating companies enters a bankruptcy proceeding. However, the opposite is the case. Courts have generally treated substantive consolidation as the exception rather than the rule because of the possibility of unfair treatment of creditors who have dealt solely with the company having a surplus as opposed to those who have dealt with related entities with deficiencies. According to one important line of cases, if a creditor opposing substantive consolidation establishes that it has relied on the separate credit of one of the entities to be consolidated and it will be prejudiced by substantive consolidation, then consolidation may be ordered only if the demonstrated benefits of consolidation "heavily" outweigh the harm.

In conclusion, the interpretation put forward by some accountants with respect to the "affiliate assumed risk" transactions discussed in this comment, that an opinion must be obtained that the transferor and the affiliate which assumes the asset-related risk would not be substantively consolidated, should be carefully examined. It is likely to have ramifications broader than just the two transaction types discussed here. It would be helpful to legal practitioners if the final auditing interpretation could make clear whether this interpretation was or was not intended by the FASB 125 Audit Issues Task Force. If the Task Force takes no view on the issue so that its resolution is left to the judgment of the auditor, this would also be helpful to know.

Thank you for your attention to this matter.

Respectfully submitted,



Adam W. Glass

AWG/cjp

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December 15, 1997

Ms. Julie Anne Dilley
Technical Manager
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1211 Avenue of the Americas
New York, NY 10036-8775

Dear Julie Anne:

I have read the proposed interpretation of AU section 336 entitled, *The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Qualifies as a Sale*, and have the following comments thereon.

In keeping with the suggestion of the SEC staff, a footnote could be added to the end of **paragraph .06**, the text of which could read as follows: "If such a legal opinion was obtained prior to the effective date of this Interpretation (see paragraph .18), an update of that opinion also may need to be obtained to confirm that the requirements of this Interpretation are met."

In **footnote 3 to paragraph .12**, I suggest changing the word "exclusion" to "omission".

I do not believe that **footnote 4 to paragraph .12** adds anything, except for the specific reference to insurance companies and banks. Also, I object to the use of the word "generally" in that footnote. Therefore, I suggest that the footnote be deleted, and the phrase "(e.g., insurance companies and banks)" be added following the reference to the U.S. Bankruptcy Code in the last sentence of **paragraph .12**.

In order to clarify the applicability of a scope exception, I suggest modifying the last sentence of **paragraph .17** to read, "...if permission for the auditor to use a legal opinion *that he or she deems otherwise adequate* is not granted, ..."

I would be pleased to discuss these comments.

Sincerely,

James S. Gerson

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(5)

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December 15, 1997

Ms. Julie Anne Dilley
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Dear Julie Anne,

We have made much progress during the Task Force's deliberations. With the possible exception of the FDIC matter, we should be in a position to finalize the Interpretation on December 18.

My comments on the November 24, 1997 draft are as follows:

Reference	Comment
Title	Suggest changing: ... That a Transfer of Financial Assets Qualifies As a Sale to ... That a Transfer of Financial Assets Has Met the Isolation Criteria in Paragraph 9(a) of Statement of Accounting Standards No. 125. Otherwise, an auditor may erroneously conclude it's not necessary to focus on paragraphs 9(b) and (c) of SFAS 125.
.04 and .05	Suggest switching the order of these paragraphs.
.06	Suggest the following changes: ... over an extended period of time ~~under that structure~~, the auditor ... ... changes in relevant law that ~~may~~ change the applicability of ...
.09	Suggest the following change: ... of the assumptions ~~that are~~ used by the legal specialist, and make appropriate test of any information ~~that~~ management provides ...

ARTHUR ANDERSEN

Reference	Comment
.10	Suggest the following change: ... content of the documentation ~~that~~ the legal specialist ...
.11	Suggest the following changes: ... legal opinion that ~~is restricted to particular~~ addresses the facts and ... ... analogy to legal precedents that ~~may not~~ involve facts that are not fully comparable ...
.12	Once the FASB provides guidance on the FDIC situation or the FDIC clarifies its policy, the Interpretation should include an example of an acceptable opinion for an FDIC insured institution. If the Interpretation is issued before the FDIC situation is resolved, a footnote should be added to explain the current FDIC situation and indicate that an example will be provided in an additional Interpretation once the situation is clarified. Also, some (I am not sure what to say) interim guidance should be provided if the Interpretation is issued before the FDIC situation is resolved. It should address both 1997 and 1998 transactions.
.13	In the last bullet point, add "or a secured borrowing" after "a sale or."
.13, FN5	The Interpretation should describe the "limited circumstances." I presume the Interpretation will be expanded and/or explained once the FDIC situation is resolved (see comment on paragraph .12).
.17	It is unclear how the auditor should determine if there is a GAAP departure or a scope limitation. The Interpretation should indicate that in the absence of a conclusive "would" or "would not" legal opinion, the auditor always has a scope exception. Refer to Exhibit I for several examples that illustrate why this is appropriate. These interpretations are included to illustrate the issues; I'm not proposing that the examples be included in the Interpretation.

ARTHUR ANDERSEN

Reference	Comment
.17 FN7	The reference to Section 336.13 should be expanded to provide the non-technician guidance on what it's about and how it's relevant. The Interpretation should indicate that the auditor should request that the client attempt to obtain a second, acceptable opinion.

* * * * * *

I look forward to our meeting on December 18. Please feel free to call if you have any questions on my comments.

Very truly yours,

ARTHUR ANDERSEN LLP

By: David N. Thrope

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ARTHUR ANDERSEN

Exhibit I

Illustration of Potential Scope Exceptions

Case	Situation
1.	Management attempts to, but cannot, obtain a legal opinion that meets the Interpretation's criteria.
2.	Management chooses not to obtain a legal opinion because management desires borrowing treatment. If management chose to, it could obtain an opinion that meets the Interpretation's criteria. (It's unclear how the auditor would know this).
3.	Management obtains a legal opinion from a firm that the auditor determines is not sufficiently "qualified" to give the opinion. The auditor does not know what opinion a "qualified" firm would provide.
4.	Management obtains an opinion from legal counsel, which restricts it from being shown to the auditor. The auditor has no basis to obtain (or rely) on the opinion, including using it to determine if there is a basis to conclude that there is a scope exception or a departure from GAAP.

(6)

CHASE

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Catherine Crowley
Senior Vice President and
Senior Associate Counsel
Legal Department

December 15, 1997

Ms. Julie Anne Dilley
Technical Manager
Audit and Attest Standards
File 2605
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Re: November 24, 1997 Draft of Proposed AU Section 9336

Dear Ms. Dilley:

The Chase Manhattan Corporation ("Chase") is pleased to take this opportunity to comment on the November 24, 1997 draft of the proposed auditing interpretation (the "Proposal") by the FASB 125 Audit Issues Task Force (the "Task Force") entitled "The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion that a Transfer of Financial Assets Qualifies As a Sale".

Chase has participated in the drafting of the comment letter to be submitted by The Bond Market Association relating to the Proposal (the "BMA Comment Letter") and supports the comments in that submission. In this letter, however, Chase seeks to focus greater emphasis on certain comments made in the BMA Comment Letter.

I. Preliminary Statement

As the largest bank holding company in the United States, Chase is an active participant in all aspects of the transfer of financial assets. Through October 31, 1997, Chase has managed, through its broker-dealer affiliate, Chase Securities Inc., approximately $32 billion in asset-backed transactions for 1997. In 1996, Chase was the second largest underwriter of credit card backed securities in the United States, acting as lead manager of $7 billion of such offerings. Chase has securitized a variety of customer receivables including credit card receivables, auto loans, retail loans, Eximbank guaranteed loans and equipment loans and leases.

In addition, Chase underwrites, advises on or participates directly in structured transactions representing billions of dollars in principal or notional principal amounts. Each one of these transactions involves the transfer of financial assets, whether to a counterparty, a trust, a special purpose vehicle or otherwise. Generally, a legal opinion concerning various aspects of the transfer is also rendered. In rendering its opinion, counsel will have undertaken whatever due diligence it deems appropriate in advising its clients that the transferred assets have effectively been isolated from the transferor. While in certain instances, counsel may be able to advise without qualification that the transfer "would" be considered a true sale in the event of the insolvency of the transferor, such opinions are rare given the legal complexities inherent in a bankruptcy or insolvency situation, particularly where the transferor is a financial institution subject to the receivership of the Federal Deposit Insurance Corporation (the "FDIC"). Because of the low level of bankruptcies of financial institutions engaged in asset securitization activities, there is insufficient case law to render such an opinion.

It should be noted that lawyers do not regularly issue formal legal opinions on bankruptcy law issues to nonclient third parties, and in the vast majority of third party opinions, bankruptcy is excepted from the scope of the opinion. See, for example, the Special Report of the TriBar Opinion Committee, *Opinions in the Bankruptcy Context: Agency, Structured Financing, and Chapter 11 Transactions*, 46 Bus. Law. 717 (1991). Conclusions as to the interpretation of bankruptcy law involve great uncertainty and heavily depend on the facts of a particular case and the broad discretionary powers of courts in this area. It is not surprising that bankruptcy opinions are recognized to be troublesome by the legal profession. Any requirement that legal opinions be required for auditors to determine the accounting treatment of transactions and the setting, by non-lawyers, of rigid criteria for the content and wording of such opinions is almost certain to lead to a stalemate between professionals of different disciplines in the context of specific transactions. Ruling that only an unqualified opinion will provide auditors with the reasonable assurance required by Statement of Financial Accounting Standards No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* ("SFAS 125") could have the effect of severely limiting certain asset securitization structures.

Institutions such as Chase involved extensively in these activities will face a dramatic increase in legal expenses if counsel is required to perform sufficient due diligence to render an unqualified opinion. And, as noted above, it is not clear that legal counsel will ever be able to provide an unqualified opinion, regardless of the due diligence undertaken. Secondly, these transactions, particularly securitizations, are time sensitive, often requiring pricing within a day. To delay the completion of these transactions because counsel is not able to provide an unqualified opinion would have a serious impact on these transactions and the capital markets generally.

II. Standard for Legal Opinions

A. Reasonable Assurance

Paragraph 23 of SFAS 125 states, in relevant part, as follows:

"The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated-put presumptively beyond the reach of the transferor and its creditors...depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered....Derecognition of transferred assets is appropriate only if the available evidence provides **reasonable assurance** (emphasis added) that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or the receiver for the transferor..."

Paragraph 23 therefore describes the standard - the "reasonable assurance" standard - to which the auditor must adhere in its determination of whether or not a transfer should be treated as a sale. SFAS 125 does not define "reasonable assurance". It is evident that the term does not mean "absolute certainty" or "slim possibility". In the context of the insolvency of a financial institution, there is no clear legal precedent governing the transfer of assets by such insolvent institution. The Proposal cannot create legal certainty where it does not exist. Because of the uncertainty in this area, Chase believes that the term "reasonable assurance" with respect to a transfer of an asset in this context means that it is more likely than not that the asset will be isolated from the transferor in the event of the bankruptcy of the transferor.

B. Paragraph 1.13 of the Proposal Rejects the Reasonable Assurance Standard

Paragraph 1.13 of the Proposal rejects as not persuasive most forms of what Chase would consider "reasonable assurance" in opinions rendered in connection with transfers of financial assets. For example, the following language is deemed to be not persuasive: "in our opinion, the transfer **should** (emphasis in the original) be considered a sale..." In rejecting this "should" opinion, the Proposal ignores the reasonableness and practicality of rendering opinions. As stated above, there is no clear legal precedent in this area. Unless there are several court cases reaching similar results, a reasonable lawyer will not give anything more than a "should" opinion because of the simple reason that the lawyer does not and cannot know the result.

Furthermore, Paragraph 1.13 of the Proposal also states that the following form of opinion is not persuasive: "There is a reasonable basis to conclude that". If the standard opinion of an auditor states "we believe that our audit provides a reasonable basis for the opinion expressed above", it is difficult to understand the logic of the Proposal requiring a more stringent standard for an opinion by a lawyer.

Given the legal uncertainties and factual dependencies in bankruptcy situations, many lawyers resist giving any bankruptcy law opinions and the form of opinions which are obtainable in this area vary widely. In various ways, by a description of the lawyer's

reasoning or by express qualifications, they put the recipient on notice of the inherent limitations in the opinion. Lawyers may feel that their conclusions are most accurately expressed by one or more of the formulations that are disapproved in the Proposal. To rigidly limit the ways in which lawyers may address the limitations of bankruptcy law opinions may simply prevent such opinions from being rendered. This will result in delays, expense and conceivably missed business opportunities.

The rejection of these types of opinion is contrary to the concept of "reasonable assurance" contained in Paragraph 23 of SFAS 125; consequently, Paragraph 1.13 of the Proposal should be deleted. In conjunction with this deletion, the Task Force should expressly adopt the "more likely than not" standard by stating that an auditor has "reasonable assurance" that a transfer has met the isolation requirement set forth in Paragraph 9(a) of SFAS 125 if the auditor has seen a reasoned opinion by a lawyer that such transfer is more likely than not to be beyond the reach of the trustee in bankruptcy (i.e., there is a greater than 50% chance that the asset will be isolated from the transferor in the event of the bankruptcy of the transferor).

C. Severe Consequences if Paragraph 1.13 of the Proposal is Adopted

As stated above, it unlikely that many opinions can be given that will be acceptable under the Proposal if Paragraph 1.13 of the Proposal is adopted. As a direct consequence, transactions in the area of securitizations and structured products will be significantly reduced and, to the extent that such transactions occur, Chase and other financial institutions will incur extraordinary costs to consummate such transactions.

III. Use of Opinions by Auditors

Chase reiterates the position in the BMA Comment Letter relating to the use by an auditor of a legal opinion. Chase believes that a review by an auditor of an opinion should constitute "use" of the opinion. Any requirement that the auditor must be able to "rely" on the opinion would also cause increased costs and undue delays. Because "reliance" is not necessary for the auditor to perform its duties, the Task Force should expressly state that a review by an auditor of a legal opinion satisfies the requirements of the Proposal.

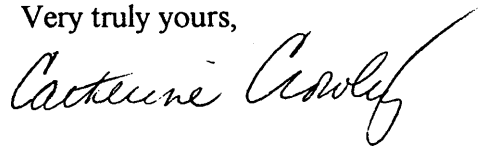
IV. Comment on Paragraphs 58 and 121 of SFAS 125

Chase strongly emphasizes the comments made in the BMA Comment Letter with respect to the importance of interested parties having the opportunity to comment on the issuance of any interpretations relating to Paragraphs 58 and 121 of SFAS 125. As stated above in the Preliminary Statement, Chase will be severely and adversely affected if changes are not made in the Proposal. If Chase had not been given the opportunity to comment on the Proposal, the Task Force would not have been fully aware of such consequences. Similarly, there may be other consequences that the Task Force should consider relating to any interpretations issued in connection with Paragraphs 58 and 121 of SFAS 125. Accordingly, it is imperative that Chase, as the parent of the largest bank in the United

States subject to FDIC receivership, and other institutions insured by the FDIC be given an opportunity to comment on such interpretations before they become effective.

Chase appreciates the opportunity to comment on the Proposal. If you have any questions, please do not hesitate to call either Joseph L. Sclafani, Executive Vice President and Controller, at (212) 270-7559 or the undersigned at (212) 270-5015.

Very truly yours,



(7)

Langer, John D

From: Langer, John D
Sent: Monday, December 15, 1997 3:04 PM
To: 'jdilley@aicpa.org'
Subject: FASB 125 Audit Issues Task Force Draft Auditing Interpretation

December 15, 1997

Ms. Julie Anne Dilley
Technical Manager
Audit and Attest Standards
File 2605
AICPA
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Ms. Dilley:

We appreciate the opportunity to comment on the FASB 125 Audit Issues Task Force draft interpretation on "The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion that a Transfer of Financial Assets Qualifies As a Sale." We believe that there are two places in the draft where the proposed language would establish a standard significantly more restrictive than the one enunciated in SFAS 125 itself.

The first of those occurs in paragraph .13 where several examples of opinion language are rejected – inappropriately in our view – as failing to provide persuasive evidence. The standard of certainty set by the FASB is that contained in paragraph 23 of Statement 125 and quoted in paragraph 1 of the draft interpretation: the evidence must provide "reasonable assurance that the transferred assets would be beyond the reach . . . ." We believe that the critical words in that phrase are "reasonable assurance;" and we believe that the FASB used those words as they are commonly used in the English language: to indicate a level of confidence substantially less than certainty. The opinion language "there is a reasonable basis to conclude that . . ." bears more than a coincidental similarity to the language FASB used. We believe that the task force, by rejecting this language as inadequate, is clearly rewriting the FASB Statement which it purports to interpret. We also believe that rejection of formulations such as "in our opinion, the transfer should be considered a sale . . ." or "in our opinion, it is probable that . . ." represents an unnecessarily narrow construction of the FASB guidance.

A smaller criticism of the phrases rejected by paragraph .13 concerns the third of those phrases: "'we are of the view . . .' or 'it appears . . .'" We fail to understand the basis on which the task force rejects these phrases without regard to the language that follows them. Would the task force really reject, as inadequate, an opinion that stated that "we are of the view that the transferred assets would be beyond the reach . . . ." If so, on what basis?

The second portion of the draft that we regard as more restrictive than Statement 125 is the language in paragraph .17 which warns that "since the isolation aspect of surrender of control is assessed primarily from a legal perspective, the auditor usually will not be able to obtain persuasive evidence in a form other than a legal opinion." With due deference to words like "primarily" and "usually," we believe this guidance will make it impossible for auditors to substitute other sources of comfort for legal assurance which, under the overly-harsh standard set by this interpretation, may not be available. The guidance contained in Statement 125 itself is much broader (again from paragraph 23): "all available evidence . . . shall be considered." We believe that the task force effectively reverses that guidance by stating that no evidence other than a legal opinion can be persuasive. Circumstances have been described to the task force which are not

matters of law but which touch directly upon the isolation of assets from their seller: for example, public policy considerations which would, quite clearly, make it highly unlikely that a potential regulatory trustee would ever pursue substantive consolidation. We believe that the draft interpretation should state that, where comfort is available from such considerations, the auditor may be able to accept legal assurances which, in the absence of such considerations, *might* provide a less than adequate level of assurance.

We would be happy to address any questions you may have about these comments.

Sincerely,
John D. Langer
Manager, Accounting Policies
Salomon Smith Barney

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THE BOND MARKET ASSOCIATION

December 15, 1997

BY HAND AND BY FACSIMILE

Ms. Julie Anne Dilley
Technical Manager
Audit and Attest Standards
File 2605
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Re: November 24, 1997 Draft of Proposed AU Section 9336

Dear Ms. Dilley:

The Bond Market Association (the "Association")[1] appreciates the opportunity to comment on the November 24, 1997 Draft of the Audit Issues Task Force ("AITF") of Proposed AU Section 9336 (the "Proposal") relating to the use of legal interpretations as evidential matter to support management's assertion that a transfer of financial

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[1] The Bond Market Association (formerly PSA The Bond Market Trade Association) represents approximately 200 securities firms and banks that underwrite, trade and sell a wide range of fixed income securities, both domestically and internationally. Among other market activities, our members are active participants in transactions involving the securitization of financial assets, both domestically and internationally, as well as a variety of other transactions involving the transfer of financial assets (e.g., repos, securities lending, participations, structured products).

In its preparation of this letter, the Association has had extensive discussions with its primary members -- securities firms and banks -- as well as its associate members -- accounting and law firms.

More information about the Association can be obtained from our website at www.bondmarkets.com.

THE BOND MARKET ASSOCIATION

assets qualifies as a sale under Statement of Financial Accounting Standards No. 125 ("SFAS 125") of the Financial Accounting Standards Board ("FASB").

We understand the AITF's desire to issue auditing guidance about the kind of evidence required to support determinations made under Paragraph 9(a) of SFAS 125. However, we believe that the Proposal's *auditing* guidance would actually change the application of the *accounting* standards promulgated in SFAS 125; in particular, the Proposal would effectively void the standard of Paragraph 9(a) that requires that a transfer put assets "presumptively" beyond the reach of creditors. As interpreted in Paragraph 23 of SFAS 125, only "reasonable assurance" is necessary, and ***the FASB specifically states in SFAS 125 that certain transfers --which would not seem to meet the standard of the Proposal -- shall be accounted for as sales***. Neither the AITF nor the ASB has authority to establish, amend or interpret *accounting* standards; it must provide *auditing* guidance within the constraints established by the *accounting* standard-setter. Simply because the *accounting* standard-setter has, in the view of the *auditing* standard-setter, created a difficult framework within which the *auditor* must perform its function, does not justify a *de facto* change of any *accounting* standard to make it more *auditor*-friendly.

Although the Association appreciates the opportunity to comment on the Proposal in this letter, we note that the comment period was only three weeks and it occurred in the middle of the holiday season. ***The Association is concerned with the AITF's apparent rush to finalize guidance, particularly in light of the significance that the Proposal would have for the financial markets.***[2] The Association is especially concerned with the AITF's statement in the cover letter to the Proposal that it intends to issue final guidance, ***without any opportunity for comment***, regarding Paragraphs 58 and 121 of SFAS 125 (transfers by FDIC-insured institutions).[3] The Association

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2 The impact of the Proposal would go beyond banks and broker-dealers; many affected parties -- accountants, auditors, lawyers, federal and state regulators and other preparers and users of financial statements -- may not even be aware of the existence of the Proposal. The normal due process of the FASB would allow a studied and fair approach to the issues raised in the Proposal.

3 The AITF states in the cover letter accompanying the Proposal that it has initiated discussions with the FASB regarding Paragraphs 58 and 121 of SFAS 125, and that it plans to include guidance based on the discussions in the final interpretation. We also understand that the AITF has requested that the FDIC confirm certain policies regarding how it might exercise its powers in case it became the receiver or conservator of an FDIC-insured institution.

THE BOND MARKET ASSOCIATION

believes it is critical that any guidance that would purport to change the accounting standard be issued in draft form with an opportunity for public and FASB comment.[4]

The Proposal should be held in abeyance until it can be considered by the appropriate accounting standard-setter, the FASB, and if amendment or interpretation of SFAS 125 is appropriate, based on FASB review, then be the subject of the normal due process of the FASB.

I. EXECUTIVE SUMMARY

The Proposal sets a rigid and restrictive standard that is far more stringent than SFAS 125 itself. *By requiring "would" opinions in the case of transfers by entities subject to the Bankruptcy Code,[5] the AITF is arbitrarily going well beyond the*

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[4] FDIC-insured banks may be directly and adversely affected by such guidance, and the AITF should not underestimate the potential negative consequences both to the institutions affected and the markets. Second, that guidance may be relevant to issues going beyond sales of assets by FDIC-insured institutions. For example, there are many parallels between the treatment of various transactions in proceedings in respect of a U.S. broker-dealer under the Securities Investor Protection Act and the treatment of those transactions in FDIC conservatorship or receivership proceedings. A full exposure of the Proposal would allow interested parties to address all of the issues raised by the Proposal.

[5] The Association does not address herein any issues regarding the specific nature of legal comfort that should be obtained in the context of transfers by FDIC-insured institutions, in light of the particular provisions of the Federal Deposit Insurance Act. As stated above, the Association believes that it is critical that any guidance regarding Paragraphs 58 and 121 of SFAS 125, particularly any guidance that would purport to change the accounting standard, be issued in draft form with an opportunity for public and FASB comment. Furthermore, although the Proposal seems to address specific legal formulations in the context of transfers by FDIC-insured institutions (see footnote 5 in the Proposal), the Proposal is ambiguous in this regard (see footnote 4 in the Proposal). The Association believes that, if the AITF disregards our comment that further public and FASB comment is necessary on the existing Proposal, it should at the very least make clear that the Proposal does not apply to transfers by FDIC-insured institutions, and then put any guidance on transfers by FDIC-insured institutions out for public and FASB

(continued...)

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"reasonable assurance" standard of SFAS 125 -- both the text of SFAS 125 and the FASB's explicit and implicit treatment of various transactions in SFAS 125 set an accounting standard different from the accounting standard that the Proposal's auditing guidance would purport to set. The Association is particularly concerned with the adverse market impact of the Proposal on sales of assets coupled with derivatives (such as structured products involving sales with total rate of return swaps), repos that currently qualify for sales treatment under SFAS 125[6] and sales effected through participations.

The Association is convinced that the "would" opinion standard in the Proposal would significantly reduce market activity in transactions such as securitizations and other structured products. These transactions are used extensively by financial institutions to repackage financial assets and instruments to meet the demands of investors and are an important source of funding for many financial institutions. Furthermore, the "would" opinion standard would unnecessarily increase costs to firms that continue to enter into sales transactions that, due to the AITF standard, would be accounted for as secured borrowings -- be they increased regulatory capital requirements or the costs arising from the perception that a firm has greater leverage. Because of these costs, firms may instead restructure certain transactions (including moving them offshore where possible)[7] solely to achieve favorable accounting treatment.

The AITF's "would" opinion standard is inconsistent with the accounting and auditing standards being applied in similar circumstances. In particular, EITF D-43

(...continued)
comment.

6 We do not address Paragraphs 9(b) or (c) of SFAS 125 herein. It is our understanding that a repo, if it met the requirements of Paragraph 9(c) (i.e., "control" is not maintained), could qualify as a sale of the underlying asset if the requirements of Paragraphs 9(a) and (b) were met. We also do not address the question of when a transaction is a "routine" transaction as discussed in Paragraph 1.04 of the Proposal, in which case legal opinions need not be obtained.

7 In certain jurisdictions, the law may be clearer on true sale issues than in the United States. For example, English bankruptcy law (which would require an English transferor) is attractive, because it is our understanding that English law generally treats transactions documented as sales as sales.

requires "reasonable assurance" based on "available evidence" that netting "would" be enforceable for a reporting entity to net off-balance sheet and repo exposures. "Would" opinions are not being required to meet those standards.[8]

There is no evidence that the FASB supports the formulaic and restrictive standard proposed by the AITF. Indeed, the Association understands that the FASB has specifically declined to impose a "would" opinion standard, let alone a legal opinion requirement in the first place.

The AITF's stringent "would" opinion standard will result in inconsistency and asymmetry in accounting treatment and will promote opinion-shopping. Different reporting entities may account for the same transactions differently, and two entities may show the same asset on their balance sheets (and be required to maintain regulatory capital against the same asset); even though the law is the same, the firms' counsel may have different views of the law or a different way of expressing their judgments. Although the Proposal recognizes that bankruptcy opinions are reasoned opinions,[9] a reasoned "would" opinion standard does not recognize the diversity of opinion practice, particularly in non-U.S. jurisdictions, and will promote opinion-shopping. A less restrictive standard will promote consistency and symmetry in accounting treatment and will reduce time-consuming and costly exercises in opinion-shopping.

Although legal opinions may be an important source, a firm should be able to provide other available evidence -- such as evidence of regulators' views -- to support its assertion that the isolation criterion has been met. For example, the regulatory policies surrounding the relationship between regulated and unregulated entities may be persuasive evidence of the separateness of those entities in bankruptcy, notwithstanding the inability of counsel to give an opinion (due to the lack of case law) that, standing by itself, does not meet the reasonable assurance standard of SFAS 125.

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8 In this regard, any final guidance should make clear that it is limited to the issue of Paragraph 9(a) of SFAS 125.

9 A reasoned opinion generally means a qualified opinion in which counsel sets forth the analysis that forms the basis of its conclusion in the opinion itself. Opinions in the bankruptcy area tend to be reasoned opinions, because of the equitable powers of bankruptcy courts and the subjective and often difficult nature of the issues being addressed.

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The treatment of a sale transaction as a financing because of the restrictive standard in the Proposal could impair a purchaser's rights in the event of a bankruptcy of the seller. A court might view a seller's treatment of a sale transaction as a financing for financial reporting purposes as evidence that the transaction should be treated as a financing for bankruptcy purposes. The Association is especially concerned that a court might base its determination on the "seller's" failure to meet the flexible language of SFAS 125, because the secured borrowing treatment was required by the Proposal. Such a result would be contrary to the intention of the parties and the otherwise likely outcome of the litigation.

The Association believes that the appropriate standard is less rigid than that proposed by the AITF, and that the "reasonable assurance" standard of SFAS 125 can be met in a number of ways. Because of the equitable powers of bankruptcy courts and the fact-specific nature of the cases, legal comfort in this area is very subjective. Furthermore, different counsel have different standards in rendering opinions; these differences may be based on, among other things, a firm's policies or the jurisdiction in which counsel practices. Instead of the imposition of an arbitrary and formulaic approach on auditors, a firm and their internal and external counsel,[10] auditors must have more flexibility in assessing legal comfort and should, where necessary, engage in a dialogue with counsel as to the level of the comfort to determine whether there is "reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee". As stated in the *topic sentence* of Paragraph 23 of SFAS 125, "[t]he nature and extent of supporting evidence . . . depend on the facts and circumstances." The Association believes that the Proposal's "check-the-box" approach is contrary to the case-by-case analysis envisioned by the FASB.

Even though the Association generally disagrees with a formulaic approach to legal comfort, it does believe that certain formulations of a lawyer's conclusion should presumptively meet the reasonable assurance standard of SFAS 125 (although that presumption could be rebutted by contrary evidence) and some should not (absent

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[10] The use of the phrase "legal specialist" in the Proposal could be taken to mean that counsel must in all circumstances be an "expert" in bankruptcy matters. We believe that, where it is appropriate to consult counsel, in many circumstances that counsel does not have to be a bankruptcy expert. For example, an internal counsel may be familiar with a transaction and, although not an expert, would feel comfortable in providing his or her legal judgment as to the treatment of the transaction in bankruptcy.

countervailing positive evidence). We discuss some specific formulations in the text below.

THE BOND MARKET ASSOCIATION

The Association emphasizes, however, that a list of formulations should not straitjacket auditors and counsel, and that auditors should be entitled to make judgments in particular cases as to whether there is "reasonable assurance." This is particularly important in the context of legal comfort from counsel in non-U.S. jurisdictions who may express conclusions in different language. The phrasing of a foreign lawyer's conclusion might seem weaker than that of a U.S. lawyer, even though it is intended to be stronger (and *vice versa*). The Proposal would not seem to allow this critical flexibility.

Firms should not be required to obtain legal comfort for every non-routine transaction; instead, memoranda of law addressing non-routine transactions meeting certain assumptions should be acceptable so long as the assumptions in the memorandum can be "matched" to the actual transaction. The Association believes that auditors should have flexibility in this regard. In certain circumstances, the auditor may be able to determine that the memorandum encompasses the transaction, while in others the auditor may need assistance either from management or counsel in making that determination. If the auditor cannot determine that the transaction fits within the advice given in the memorandum, it would then seek additional evidence as appropriate. Again, the Association believes this flexibility is entirely consistent with the spirit and letter of SFAS 125.

Finally, the Association agrees that auditors entitled to seek legal comfort as evidence to support a firm's assertions should be entitled to review that comfort and that certain limitations in a legal opinion would be inconsistent with the auditor's use of the legal comfort. The Association does not believe, however, that a limitation on auditors' "reliance" itself unduly restricts the use by the auditor of the legal comfort.

In light of our concern with the impact of the Proposal on the markets and our concern that the Proposal would change generally accepted accounting principles without the normal FASB due process, it is imperative that the next version of the Proposal, if any, should be put out for an extended period of public and FASB comment and that any guidance regarding Paragraphs 58 and 121 of SFAS 125 should also be the subject of public and FASB comment.

THE BOND MARKET ASSOCIATION

II. DISCUSSION

A. The AITF's "Would" Opinion Standard is Far More Restrictive Than SFAS 125; SFAS 125 Requires Only Reasonable Assurance

Although the Proposal does not expressly state that a "would" opinion from counsel is required for a firm to meet the isolation criterion in Paragraph 9(a) of SFAS 125, it is the Association's understanding that Paragraphs 1.13 and 1.17 of the Proposal make this requirement for "non-routine" transactions clear by negative implication. Under Paragraph 1.13, a "should" opinion would not provide persuasive evidence, and under Paragraph 1.17, an auditor will "usually" not be able to obtain persuasive evidence in a form other than a legal opinion.

The Association agrees that there is a significant degree of legal content to Paragraph 9(a) of SFAS 125, and that legal comfort from qualified counsel may be an important means for an auditor to obtain evidence of a firm's assertion that the isolation criterion has been met for "non-routine" transactions. However, we strongly believe that SFAS 125 itself does not require, and the FASB has not interpreted SFAS 125 to require, that the legal comfort must come in the form of a legal opinion or that the comfort must meet an inflexible and stringent "would" opinion standard. Instead, SFAS 125 sets forth a "reasonable assurance" standard as to both form and substance that is to be applied in a case-by-case manner on the basis of all available evidence. ***The Association therefore believes that the Proposal would actually change generally accepted accounting principles, and we question the AITF's authority to make such a change.***

1. The text of SFAS 125 itself sets forth a standard much less restrictive than the "would" opinion standard in the Proposal

The Association believes that the text of SFAS 125 sets forth a lesser standard than a "would" or "should" opinion standard. The wording of the text of SFAS 125 can support a number of possible interpretations as to the level of comfort that must be obtained to meet the Paragraph 9(a) standard. Based solely on a textual analysis, one can make arguments for a variety of standards, ranging from a "would/should" opinion standard to a "more likely than not" standard.[11] Given these "mixed signals", it is

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[11] "Presumptively" (which in layman's terms seems to be a relatively flexible standard) appears, of course, in Paragraph 9(a) itself and would seem to suggest a very low standard. The reference in Paragraph 57(a) to sales to SPE's being "likely" to be judged beyond the reach of the transferor implies a

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unclear why the AITF chose the most restrictive interpretation, especially in light of the words of Paragraph 23 that seem to bear most directly on the question of the standard of the legal comfort:

> The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated . . . may include making judgments about . . . whether a transfer of financial assets ***would likely*** be deemed a true sale at law . . . . Derecognition of transferred assets is appropriate only if the available evidence provides ***reasonable assurance that the transferred assets would*** be beyond the reach of the powers of a bankruptcy trustee.... (Emphasis added.)

The Association believes that Paragraph 23 itself sets forth the appropriate standard; that standard is a "would likely/reasonable assurance" standard and not a "would" opinion standard.

To the extent that there is textual ambiguity, however, the Association believes that one can go beyond the mere words of SFAS 125 and look to the FASB's explicit and implicit treatment of various transactions in SFAS 125. The lengthy accounting guidance given by the FASB in SFAS 125 in connection with repos, participations and other trading transactions strongly supports the view that a "reasonable assurance" standard (and certainly not an inflexible "would" standard) is the appropriate standard.

2. A "Would" Opinion Standard is Contrary to the FASB's Treatment of Repos and other Transactions in SFAS 125.

Paragraph 24 of SFAS 125 indicates that "many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other

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"more likely than not" standard. On the other hand, the reference in Paragraph 118 to assurances acceptable to rating agencies implies a "would/should" standard (***as discussed below, the rating agencies will often accept "should" opinions***). Notably, Paragraph 118 does not form an integral part of SFAS 125, as it is contained in Appendix B (unlike Paragraphs 22 through 84, which are contained in Appendix A).

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criteria for surrender of control."[12] Furthermore, Paragraph 68 states that "... transfers ... that ***shall*** be accounted for as sales include transfers with agreements to repurchase at maturity and transfers with repurchase agreements in which the transferee has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement assets." (Emphasis added.)[13]

The FASB's statement that repos would qualify for isolation under Paragraph 9(a) is inconsistent with the view that a "would" opinion is required for derecognition. Indeed, the FASB recognizes that repos are "ambiguous" and "difficult to characterize".[14] Transactions that are "ambiguous" are hardly susceptible to the receipt of the definitive legal comfort required by "would" opinions. Rather, the

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12 The minutes of the March 27, 1996 meeting of the FASB indicate that :

"Mr. Bullen recommended that the final Statement note in Appendix A that certain transactions meet criterion 9a, even though they may not meet the other control criteria, for example, repurchase agreements, securities lending transactions, and loan participations. He stated that would help accountants and preparers understand the criterion. No Board members disagreed with the staff recommendation." (Emphasis added.)

See also Paragraph 138 of SFAS 125: "if judged by the criteria in paragraphs 9(a) and 9(b) . . ., financial assets transferred under typical repurchase . . . agreements would qualify for derecognition as having been sold for proceeds consisting of cash and a forward purchase contract."

13 We understand that the AITF believes that the "would" opinion standard is required by Paragraph 23 of SFAS 125 (even though that Paragraph, as discussed above, speaks of "reasonable assurance" that a transfer "would" be considered a sale). Notably, Paragraphs 24 and 68 are of the same importance in interpreting SFAS 125 as Paragraph 23; each is in Appendix A ("Implementation Guidance") and each is an "integral part of the standards provided in" SFAS 125 (Paragraph 22). We assume that no legal opinion or other comfort would be required if transactions described in Paragraph 68 are treated as sales in accordance with the prescriptions established by the FASB in that Paragraph.

14 Paragraphs 135 and 142 of SFAS 125.

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FASB's statement that typical repos are "generally" treated as sales in bankruptcy is entirely consistent with a "reasonable assurance" standard. [15]

Similarly, the FASB seemed clearly to contemplate that participations would qualify for derecognition in many circumstances (see Paragraphs 74-76), yet even well-drafted participations sold without recourse can pose creditors' rights issues. [16] ***Again, this strongly supports the conclusion that the Proposal's "would" opinion requirements go well beyond SFAS 125.*** [17]

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15 The Federal Reserve Bank of New York, in an amicus brief filed with the U.S. Supreme Court in Nebraska Dept. of Rev. v. Lowenstein, 115 S.Ct. 557 (1994), a recent tax case involving repos, cautioned the Court that "characterization of repos is a dangerous process." Repos are hybrid transactions that are often characterized differently for different purposes (i.e., commercial law, tax and bankruptcy). Because of the difficulty in characterizing repos as either purchases and sales or secured borrowings for bankruptcy purposes, special bankruptcy protections have been enacted in order to protect the functioning of a vitally important financial market. In light of this difficulty, it is very unlikely that any legal specialist would be able to provide a "would" opinion that a repo constitutes a true sale. The fact that the FASB, obviously keenly aware of the "difficult to characterize" nature of repos, would state that they meet the isolation criterion of Paragraph 9(a) is strong evidence that a "would" level of legal assurance was not intended by the FASB to be the standard for isolation.

16 Participations have been the subject of a great deal of insolvency case law, principally involving banks. Although most of that case law indicates that, where a lead lender sells a participation without recourse, the underlying asset (or portion thereof subject to the participation) is not property of the lead's estate, the case law is not entirely uniform. In addition, if the underlying borrower has a deposit with the lead, it can set off its obligations under the loan against the deposit obligations of the lead, notwithstanding the participation of the loan (and to the detriment of the participant). This legal landscape seems inconsistent with a "would" opinion standard, yet the FASB seemed clearly to contemplate that participations would qualify under Paragraph 9(a) of SFAS 125.

17 Outside of the context of repos and participations, the majority of examples in SFAS 125 suggest that many transactions that would not meet a "would" opinion requirement should nonetheless meet the isolation standard of Paragraph 9(a). See Paragraphs 6, 32, 41 and 46, which imply that a put

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3. A "would" opinion standard would be inconsistent with other similar accounting standards

EITF D-43, which interprets FIN 39 (and FIN 41[18]) states that "[o]ffsetting is appropriate only if the available evidence, both positive and negative, indicates that there is reasonable assurance that the right of setoff would be upheld in bankruptcy." This standard is remarkably similar to that in Paragraph 23 of SFAS 125.[19] We do not believe that "would" or "should" opinions are, or have been, required to meet the FIN 39 and FIN 41 standards, but instead that the standard has been applied flexibly and that memoranda or other legal diligence, together with other available evidence,[20] conveying a "would likely" confidence level have been viewed as sufficient.

EITF D-43 also states that "all of the information that is available, either supporting or questioning enforceability, should be considered." Again, this is remarkably similar to the statement in Paragraph 23 of SFAS 125 that "[a]ll available evidence that either supports or questions an assertion shall be considered." Implicitly in both of these standards, information questioning enforceability is not necessarily inconsistent with reasonable assurance; on the other hand, it might well be inconsistent with a "would" or "should" opinion.[21]

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should be treated the same whether written by the seller of the subject asset or a third party and that sales of loans with recourse should be treated as sales. When a put is issued by a seller of an asset or when loans are sold with recourse, there may well be true sale issues inconsistent with "would"-level comfort.

18 The FIN 39 standard is incorporated into FIN 41 (netting of repos).

19 Of course, the AITF Proposal would only apply to determinations under Paragraph 9(a) of SFAS 125. In light of the similarity of wording between Paragraphs 23 of SFAS 125 and EITF D-43, however, the Association believes that the AITF should make the limited application of the Proposal clear in any final guidance.

20 For example, we believe that firms have supported offsetting with certain counterparties on the basis of regulatory pronouncements or realities, even if there is no traditional legal comfort that offsetting would be enforceable.

21 The "all available evidence" standard of diligence that balances positive and

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Notably, there appear to be substantial similarities between the reasonable assurance required for netting under FIN 39 and FIN 41 and derecognition under SFAS 125 -- in addition to the similarities in language, FIN 39, FIN 41 and SFAS 125 go to the legal underpinnings for accounting treatment and rely in large part on counsel's judgments as to difficult-to-evaluate bankruptcy issues.[22] ***The Association believes that the flexibility that has been applied in implementing FIN 39 and FIN 41 is appropriate and consistent with the spirit and letter of EITF D-43; the AITF should apply the spirit and letter of SFAS 125 similarly.***

4. The FASB has declined to mandate a "would" standard

SFAS 125 never states that legal opinions should be required or that a "would" or "should" standard is required. Furthermore, we understand that several of the Association's members and counsel have since the publication of SFAS 125 participated in meetings with members and staff of the FASB and that the FASB has declined to indicate that opinions would be required or that they would have to meet a "would" standard.

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negative evidence is echoed in SFAS 109 (Accounting for Income Taxes). Paragraph 20 of SFAS 109 states that "[a]ll available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, a valuation allowance is needed." The Summary further states that "[j]udgment must be used in considering the relative impact of negative and positive evidence.... The more negative evidence that exists (a) the more positive evidence is necessary and (b) the more difficult it is to support a conclusion that a valuation allowance is not needed." Again, the balancing of positive and negative evidence, when applied to a lawyer's judgment, may well be inconsistent with a "would" or "should" opinion.

22 The other area in which counsel's judgments are often used as evidence to support accounting conclusions is under SFAS 5 (Accounting for Contingencies). Paragraph 36 of SFAS 5 indicates that, *among other factors*, the "opinions *or* views" of legal counsel should be considered. The Association believes that, although the language of Paragraph 36 of SFAS 5 is not so nearly identical to Paragraph 23 of SFAS 125 as are EITF D-43 and Paragraph 20 of SFAS 109, it conveys the same message: auditors must be flexible in evaluating legal evidence in evaluating a firm's assertions.

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The Proposal's rigid and stringent "would" opinion standard thus goes far beyond SFAS 125 and the intention of the FASB. The Proposal's standard is inconsistent with the explicit and implicit treatment by the FASB of various transactions in SFAS 125, is inconsistent with other similar accounting standards and has never been endorsed by the FASB. The Association does not believe that the AITF has the authority to make this change to generally accepted accounting principles, and believes that any final guidance must be the subject of an opportunity for an extended period of public and FASB comment.

B. A "Would" Standard Would Not Change the Law or Make the Law Clearer and Would Result in Inconsistency and Asymmetry of Accounting Treatment and Will Promote Opinion-shopping

A lawyer's opinion as to whether a sale of financial assets will be respected as such in a bankruptcy will not, of course, necessarily produce that result. Instead, a lawyer's opinion (particularly in the case of bankruptcy opinions) is more in the nature of a prediction, based to the extent possible on prior case law, of how a court is likely to view the particular facts of a transaction. Because of the predictive nature of legal comfort, and because different counsel have different standards in rendering opinions,[23] a strict "would" opinion standard would promote inconsistency, asymmetry and opinion-shopping. On the same facts, different counsel may well come to different conclusions; some counsel may reach a "would" level of comfort, others may not. *A "reasonable assurance" standard would result in greater consistency and comparability and still provide a strong degree of legal comfort that transferred assets have been placed beyond the reach of creditors; the differing approaches of counsel would be more likely to satisfy this flexible standard and different firms would be more likely to account for similar transactions in the same way.*

A less restrictive standard will not only promote consistency, it will promote symmetry (one of the principal goals of the financial components approach of SFAS

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[23] There is a wide range of opinion practices in the United States. For example, some counsel do not even believe there is a difference between a "would" and a "should" opinion while others do. The AITF's Proposal fails to recognize this diversity.

125); assets will not be shown on two firms' balance sheets at the same time and only one firm will have to maintain regulatory capital against those assets. Furthermore, it will reduce opinion-shopping; the Proposal's "would" standard would cause firms to consider searching for counsel that is willing to render a "would" opinion in lieu of counsel that, in the same transaction, would not.

These issues are likely to be exacerbated in the case of transfers of financial assets by non-U.S. affiliates of U.S. reporting firms. Because the AITF's Proposal does not recognize the diversity of legal opinion practice even in the U.S. context, it will likely have an even more adverse effect in non-U.S. jurisdictions where the distinctions drawn by lawyers in the U.S. between "would" and "should" are likely to be foreign. The Association believes that the AITF must not underestimate the impact of the Proposal on the ever-increasing amount of asset securitization and other sales transactions that are being done by foreign affiliates of U.S. reporting firms. The legal formulas used in the United States should not be imposed on non-U.S. counsel by virtue of auditing practices. A more flexible and less formulaic standard would accommodate the practices of non-U.S. lawyers providing comfort in non-U.S. transactions.

C. Traditional Legal Comfort (Opinions and Memoranda of Law) Should Not Be the Only Form of Persuasive Evidence

Paragraph 1.17 of the Proposal states that "the auditor usually will not be able to obtain persuasive evidence in a form other than a legal opinion." The Association believes that although traditional legal comfort (whether in the form of an opinion or a memorandum of law[24]) may in many circumstances be an important element in the auditor's determination, in many circumstances other evidence may be persuasive. The Proposal does not give adequate recognition to the forms of "available evidence" that Paragraph 23 of SFAS requires a firm to consider in "making judgments" regarding a transfer. The very first sentence of Paragraph 23 states that the "nature and extent of supporting evidence" . . . "depend on the facts and circumstances."

For example, in the case of a sale by a broker-dealer to a third party executed simultaneously with a derivatives contract between the third party and an affiliate of the seller, the issue of substantive consolidation in bankruptcy between the seller and its affiliate could be relevant to the question of isolation; if the seller and the affiliate were consolidated, counsel might not be able to provide reasonable assurance

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[24] We discuss our views on opinions versus memoranda of law below.

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regarding true sale issues. If the affiliate is not a special purpose entity, counsel might find it difficult to render an opinion that the seller and the affiliate should not be consolidated in light of the highly fact-intensive nature of substantive consolidation analysis and the non-special purpose nature of the affiliate in question. Nonetheless, a firm may be able to obtain comfort that does not take the form of traditional legal comfort, because it is not based on case law, that provides persuasive evidence to the auditors. For example, in the case of a broker-dealer seller, evidence of the regulators' views would be highly probative of the likelihood of consolidation (or the likelihood of litigation), yet would not form the basis of a legal opinion. [25]

Of course, evidence of the regulators' views should not be viewed in isolation, and should be evaluated along with any legal comfort obtained; together, they might provide reasonable assurance that the assets would be beyond the reach of the transferor or they might not. The fact, however, that the legal comfort alone does not provide such assurance should not preclude the totality of the evidence from providing such assurance.

D. The Treatment of a Sales Transaction as a Financing Could Impair a Purchaser's Rights in the Event of a Bankruptcy of the Seller.

A court might view a seller's treatment of a transaction structured as a sale as a financing for financial reporting purposes as evidence that the transaction should be treated as a financing for bankruptcy purposes. Because of the "disconnect" between SFAS 125 and the Proposal, the Association is especially concerned that a court might base its determination on the express language of SFAS 125 rather than the proposed "auditing" standard in concluding that the seller could not even provide reasonable assurance that the transfer would be viewed as a sale in bankruptcy. For example, if counsel could render a conclusion that it would be likely that a sale of an asset coupled with a total rate of return swap would be treated as a sale of the asset, yet the transfer

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[25] Footnote 2 of the Proposal is thus unsatisfactory, in that implies that the legal specialist should consider applicable regulatory policies in arriving at a legal conclusion. Indeed, a legal specialist may find it inappropriate to base any legal conclusion on the policies of a regulator. Our point is that regulatory policy, which may have a significant bearing on the probable outcome of any litigation or whether litigation is even brought, is not susceptible to traditional legal comfort yet is very relevant to, if not determinative of, the issue of isolation.

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was accounted for as a secured borrowing, it is possible that in a bankruptcy of the seller, the seller's accounting treatment of the transaction would be used against the purchaser (who would, of course, take the position that the transaction was a sale). The Association has been involved in several efforts to clarify the treatment in bankruptcy of various financial transactions to comport with the parties' expectations as to the treatment of those transactions (for example, the provisions of the Bankruptcy Code protecting the rights of purchasers of assets under repos).[26] The Association is very concerned that the AITF's Proposal would undercut these efforts and would produce perverse results.

E. The "Reasonable Assurance" Standard is Not a Formula and Can Be Met in a Number of Ways

Paragraph 23 of SFAS 125 clearly indicates that meeting the isolation standard of Paragraph 9(a) is not a matter of checking a box. Instead, it is a facts-and-circumstances endeavor that is designed to provide reasonable assurance that an asset would be beyond the reach of creditors. The Proposal attempts, on the other hand, to force lawyers' conclusions into a narrow and inflexible formula. Because of the equitable powers of bankruptcy courts and the fact-specific nature of bankruptcy cases, legal comfort in this area is inherently very subjective. Furthermore, different counsel have different standards in rendering opinions.[27] While the Association understands that the AITF believes that the Proposal would be easy to implement, it simply ignores the reality of the uncertainty in this area. *Instead of the imposition of an arbitrary and formulaic approach on auditors and counsel, auditors should be able to exercise judgment in assessing legal comfort and should, if necessary or appropriate, engage*

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26 More recently, the Association has been working with the President's Working Group to make several changes to U.S. bankruptcy and insolvency laws. See in this regard "Financial Transactions in Insolvency: Reducing Legal Risk Through Legislative Reform", a position paper prepared jointly by the Association and the International Swaps and Derivatives Association, Inc. (April 2, 1996).

27 For instance, some counsel may be comfortable giving a legal conclusion in a highly subjective area if they believe that they will not be liable for negligence in rendering that conclusion. Other counsel may instead require affirmative case law support for a conclusion. Some counsel may be more concerned with reputational issues than other counsel. These are just some examples of the different considerations that different legal specialists consider in approaching opinion practice.

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in a dialogue with counsel to ascertain the level of counsel's comfort to determine whether the "reasonable assurance" standard of SFAS 125 has been met.

Even though the Association generally disagrees with a formulaic approach to legal comfort, it does believe that certain formulations of a lawyer's conclusion should presumptively meet the reasonable assurance standard of SFAS 125 (although that presumption could be rebutted by contrary evidence). For example, the Association believes that the following formulations (most of which are taken from Paragraph 1.13 of the Proposal) of counsel's conclusions would presumptively provide persuasive evidence that the isolation criterion has been met:

- "In our opinion, the transfer should be considered a sale."[28]
- "We are of the view that a court would ..."[29]
- "There is a reasonable basis to conclude that ..."
- "We believe a court would likely..."
- "Although the matter is not free from doubt, it is our opinion that a court would ..."

Similarly, the Association believes that certain formulations of a lawyer's conclusion from Paragraph 1.13 of the Proposal should presumptively not provide persuasive evidence that the isolation criterion has been met (unless other available evidence supports isolation):

- "We are unable to express an opinion."

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28 Some rating agencies will accept "should" opinions in certain circumstances (e.g., in opinions regarding substantive consolidation); thus, even under the most restrictive view of SFAS 125, "should" level comfort should constitute persuasive evidence. This conclusion is supported by the view of some, but not all, U.S. counsel that there is no difference between a "would" and "should" opinion.

As noted above, we do not address in this letter the level of comfort that should be acceptable in the case of transfers by FDIC-insured banks (such as the "either there is a sale or there is a perfected security interest" opinions routinely rendered to the rating agencies in securitizations by FDIC-insured institutions). Again, we believe it is critical that the public and the FASB be given an opportunity to comment on any guidance in this regard.

29 The AITF's proposed acceptance of counsel's "belief" (see Paragraph 1.12) but not its "view" (see Paragraph 1.13) seems counterintuitive.

- "It is our opinion, based upon limited facts..."
- "In our opinion, there is a reasonable possibility..."
- "It is our opinion that the company will be able to assert meritorious arguments..."

The Association emphasizes, however, that these formulations should not box auditors and counsel in, and that auditors should be entitled to make judgments in particular cases as to whether there is "reasonable assurance." The auditor's judgment should be made on a case-by-case basis, and the fact that a formulation is not listed above (or in Paragraph 1.12) should not automatically mean that it does not provide reasonable assurance as to isolation.

This is particularly important in the context of legal comfort from counsel in non-U.S. jurisdictions who may express conclusions in different language. The Association believes it is simply inappropriate for the AITF to export U.S. linguistic norms to non-U.S. counsel and that the Proposal must allow for greater flexibility in this regard.

F. Legal Comfort Can Take the Form of a Memorandum of Law and Does not Have to be Obtained for Every Non-Routine Transaction

Paragraph 1.13 of the Proposal states that "conclusions about hypothetical transactions may not be relevant to the transaction that is the subject of management's assertions. . . . [C]onclusions about hypothetical transactions may not contemplate all of the facts and circumstances or the provisions in the agreements of the transaction that is the subject of management's assertions, and generally would not provide persuasive evidence." The footnote to this statement reads as follows: "a memorandum of law from a legal specialist usually analyzes (and may make conclusions about) a transaction that may be completed subsequently. Such memorandum generally would not provide persuasive evidence, unless the conclusions conform with this interpretation and a legal specialist opines that such conclusions apply to a completed transaction that is the subject of management's assertion."[30]

The Association believes that the lack of flexibility reflected in Paragraph 1.13 is inconsistent with SFAS 125 and that it is unnecessary for firms to incur the expense associated with a legal opinion for every transaction in order for auditors to become comfortable with management's assertions regarding Paragraph 9(a) of SFAS 125. While we agree with the concept that some diligence needs to be done to ensure that a

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30 We agree with the statement in the footnote, to the extent it implies that a memorandum of law *can* provide persuasive evidence.

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particular non-routine transaction fits within the parameters of an opinion or memorandum of law that makes assumptions about a transaction, we do not believe that counsel must in all cases "match" the transaction to the opinion or memorandum. Instead, in many cases, the auditor may be able to determine that the memorandum encompasses the transactions, while in others the auditor may need assistance either from management or a lawyer (including a lawyer that is not an expert in bankruptcy matters) in making that determination. If the auditor, on the basis of this diligence, cannot determine that the transaction fits within the advice given in the memorandum, then in appropriate circumstances, additional evidence would be sought.

G. Auditors Should be Entitled to Review, but not Rely on, a Lawyer's Conclusions

Paragraph 1.15 of the Proposal states that "an auditor should not use as evidence a legal opinion that . . . *restricts use* of the findings expressed therein . . . ." (Emphasis added.) The Association agrees that language in the legal conclusion flatly prohibiting the use of the conclusion by the auditor may not be acceptable. In this regard, we believe that it should be sufficient for counsel to acknowledge that its client may show a copy of the legal conclusion to its auditors for the purpose of the auditors' evaluation of the firm's assertions in its financial statements. Counsel should not, however, be required to allow the auditors to "rely" on the conclusion.[31]

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[31] Language such as that found in Paragraph 7 of the American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975) is an example of an approach that the Association believes should be acceptable. That Paragraph, which is often incorporated by reference in counsel's responses to auditors' requests for information pursuant to SFAS 5, provides as follows:

"Limitation on Use of Response. Unless otherwise stated in the lawyer's response, it shall be solely for the auditor's information in connection with his audit of the financial condition of the client and is not to be quoted in whole or in part or otherwise referred to in any financial statements of the client or related documents, nor is it to be filed with any governmental agency or other person, without the lawyer's prior written consent. Notwithstanding such limitation, the response can properly be furnished to others in compliance with court process or when necessary in order to defend the auditor against a challenge of the audit by the client or a regulatory agency, provided that the lawyer is given written notice of the circumstances at least twenty days before the response is so to be furnished to others, or as long in advance as possible if

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For the foregoing reasons, the Association strongly urges the AITF to hold the Proposal in abeyance until it can be considered by the FASB and be the subject of the normal due process of the FASB, including an opportunity for public comment.

III. CONCLUSION

We would be happy to discuss our views at your convenience. Please contact either of the undersigned at (212) 440-9400 or our special counsel in this matter, Seth Grosshandler of Cleary, Gottlieb, Steen & Hamilton, at (212) 225-2542 with any questions or comments.

Sincerely,

Paul Saltzman
Senior Vice President and General
Counsel

Patricia E. Brigantic
Vice President and Assistant General
Counsel

cc: Michael Sutton, Chief Accountant,
Securities and Exchange Commission
Richard R. Lindsey, Director, Division of Market Regulation
Securities and Exchange Commission
Robert L. Colby, Deputy Director, Division of Market Regulation,
Securities and Exchange Commission
Michael A. Macchiaroli, Associate Director, Division of Market Regulation,
Securities and Exchange Commission
Thomas Bolt, Esq. Counsel,

(...continued)
the situation does not permit such period of notice."

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Federal Deposit Insurance Corporation
Roger Anderson, Deputy Assistant Secretary for Federal Finance
U.S. Department of the Treasury
Mark Tenhundfeld, Assistant Director of Legislative and Regulatory Activities
Office of the Comptroller of Currency
Thomas M. Corsi, Senior Attorney, Legal Division
Federal Reserve Bank
Christine Harrington, Counsel, Regulations and Legislation Division
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December 15, 1997

Ms. Julie Anne Dilley
Technical Manager
Audit and Attest Standards
File 2605
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Re: November 24, 1997 Draft Proposal of AU Section 9336

Dear Ms. Dilley:

Bankers Trust New York Corporation appreciates the opportunity to comment on the November 24, 1997 Draft of the Audit Issues Task Force ("AITF") of Proposed AU Section 9336 (the "Proposal"), relating to the use of legal interpretations as evidential matter to support management's assertion that a transfer of financial assets qualifies as a sale under Statement of Financial Accounting Standards No. 125 ("SFAS 125") of the Financial Accounting Standards Board (the "FASB").

Bankers Trust New York Corporation is a bank holding company that, as of September 30, 1997, had consolidated total assets of $140.1 billion. Its principal banking subsidiary, Bankers Trust Company, is among the largest commercial banks in New York City and the United States, based on consolidated total assets. Among its other subsidiaries is BT Alex. Brown Incorporated, an SEC-registered broker-dealer that is a leading provider of financing to fast-growing companies.

General

We believe that the Proposal establishes an unreasonably high evidential standard that is not required by SFAS 125 itself or by current practices in related areas. We believe that such a standard would lead to inaccurate and inconsistent accounting treatment of transactions and would result in the incurrence of excessive costs of compliance. We believe that the "reasonable assurances" evidential standard for "isolation" required by SFAS 125 should be permitted to be met through the receipt of legal advice in forms other than legal opinions of the type required by the Proposal and that such a standard would enable accounting treatment to more accurately reflect economic and legal realities, promote consistency and symmetry and prevent excessive costs from being incurred.

SFAS 125 and the Proposal

Paragraph 9 of SFAS 125 permits a transfer of financial assets to be accounted for as a sale only when the transferor has "surrendered control" thereof. Paragraph 9(a) establishes as one of the conditions to evidence surrender of control that "[t]he transferred assets have been isolated from the transferor -- put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership". Paragraph 23 of SFAS 125 describes the accountants' task as "**making judgments** [about] whether a transfer of financial assets **would likely** be deemed a true sale at law" and establishes as the evidential standard for "isolation" whether available evidence "provides **reasonable assurance** that the transferred assets **would** be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates" (emphasis added).

SFAS 125 itself does not require, and the FASB has not interpreted SFAS 125 to require, that this "reasonable assurance" come in the form of an unqualified legal opinion. In Paragraphs 82 and 101 of the Exposure Draft of October 24, 1995 of SFAS 125, the FASB expressly did not require any legal opinions whatsoever. While the final version of SFAS 125 did not contain these express disclaimers, neither SFAS 125 nor the FASB stated that a legal opinion would be required. In fact, Paragraph 119 of SFAS 125, which was derived from Paragraph 101 of the Exposure Draft, in addressing concerns about the feasibility of basing an accounting standard on legal considerations, continues to state that "having to consider only the evidence available should make that requirement workable".

The Proposal, by contrast, essentially requires that, with respect to all transfers of financial assets other than "routine" transfers that "do[] not result in any continuing involvement by the transferor", a legal opinion be obtained to the effect that (i) the transferred financial assets would not be deemed to be property of the transferor's estate for purposes of applicable insolvency law and (ii) a court would not grant an order consolidating the assets and liabilities of the transferee with those of the transferor in a case involving the insolvency of the transferor.

We believe that such legal opinion requirement sets a standard far in excess of that necessary to obtain the "reasonable assurance" of isolation required by SFAS 125, and that such "reasonable assurance" standard should be permitted to be met through the receipt of legal advice in forms other than legal opinions of the type required by the Proposal.

As described below, lawyers' standards for rendering legal opinions in the form required by the Proposal are sufficiently high, and insolvency law is sufficiently uncertain, that, even in situations where it is highly likely that "isolation" has been achieved, the required legal opinion may not be able to be rendered. In practice, the effect of the Proposal would be to cause transactions that, based on the preponderance of the evidence, should be characterized as sales, to be characterized as secured borrowings. Transferors in transactions that are not cleanly "opinionable" will therefore report artificially high levels of assets on their balance sheets and, in the case of regulated financial institutions, artificially low capital adequacy and leverage ratios.

In addition, because opinion practice will undoubtedly vary from law firm to law firm, such a standard could result in inconsistent accounting treatment of a given type of transaction and, where two parties to a transaction are receiving legal opinions from different firms, asymmetrical accounting of a single transaction, resulting in the "double counting" of assets. Moreover, whether a legal opinion is obtained with respect to a given transaction will often depend upon considerations of cost and timing. In short, such a standard would encourage accounting that does not accurately reflect underlying economic and legal realities and that could result in inconsistent and asymmetric treatment of transactions.

Use of Legal Advice in Other Areas of Accounting

In other areas of accounting, even areas where there is some degree of reliance upon legal advice, the degree of certainty required by the Proposal with respect to the legal consequences is not required. For example, FIN 39 and FIN 41 (which incorporates the FIN 39 standard), regarding the offsetting of certain contracts, require a determination to be made as to whether a purported right of setoff is enforceable at law -- that is, whether it would be respected in a bankruptcy of the counterparty. The interpretation of FIN 39 contained in EITF D-43 provides that "[o]ffsetting is appropriate only if the available evidence, both positive and negative, indicates that there is a **reasonable assurance** that the right of setoff **would** be upheld in bankruptcy" (emphasis added). This standard, which closely parallels the "reasonable assurance" standard of Paragraph 23 of SFAS 125, has not been interpreted to require evidential matter in the form of "would" legal opinions. In fact, EITF D-43 itself recognizes that "[t]he nature of support required for an assertion in financial statements that a right of setoff is enforceable at law is subject to a cost-benefit constraint and depends on facts and circumstances."

Determination of legal title to assets is another area in which the work of a legal specialist is relied upon to determine accounting treatment. Accounting practice has not required that legal advice with respect to title matters, when obtained, come in the form of an unqualified legal opinion.

Legal Opinions

Lawyers require an extremely high degree of certainty to be able to render a legal opinion that is not "reasoned" or otherwise qualified in a manner that would conflict with the Proposal. Rendering "clean" opinions in an insolvency context is especially problematic because there is often no statute or other dispositive legal rule that governs whether property would or would not be included in the insolvency estate of a debtor. Generally, it is necessary for lawyers to rely upon case law which was decided by courts other than final courts of appeal (and are therefore not necessarily dispositive) or in factual situations that are not identical to the factual situation with respect to which counsel is opining. Because of this, it is often not possible to achieve certainty either as to what the law is in a particular context or whether the law would be applied in a particular way in a given factual context. Therefore, legal opinions in this area are often "reasoned" opinions where the lawyer takes what he or she believes to be the salient facts in

relation to the matter being opined upon and applies what legal precedent he or she believes is relevant to the analysis, to reach a conclusion about what a court might do in a particular situation.

The difficulty of obtaining legal opinions is compounded in the case of multi-jurisdictional transactions or transactions in a single jurisdiction involving different insolvency regimes (for instance, in the U.S., corporations are generally subject to the U.S. Bankruptcy Code, while insured depository institutions are subject to the Federal Deposit Insurance Act and insurance companies are subject to state law). Many jurisdictions may not have developed or precise rules in this area. In addition, there may be more than one legal system whose substantive laws would be relevant to a particular transaction, and the jurisdiction of organization of a party will not always be determinative. For example, a foreign company with U.S. assets could be subject to a bankruptcy proceeding in U.S. courts under the U.S. Bankruptcy Code, as well as being subject to the insolvency law of its home jurisdiction in proceedings in the courts of such jurisdiction.

The difficulties in obtaining legal opinions on a single legal point with respect to multiple jurisdictions is well illustrated by the efforts of the International Swap and Derivatives Association, Inc. (the "ISDA") in the area of swap netting. Over the course of the last several years, the ISDA has been soliciting opinions from law firms in nations around the world as to the enforceability of the netting provisions in the ISDA's standard-form master swap agreement. Despite several years of effort, opinions have still not be obtained with respect to all significant jurisdictions or all insolvency regimes in the jurisdictions for which opinions have been obtained. Thus, even where legal opinions with respect to a standard-form document are being relied upon with respect to a class of transactions, the process of obtaining such opinions in multiple jurisdictions would take a great deal of time and effort to implement.

It appears that the legal opinion standard contained in the Proposal has been taken from the rated asset-backed securities context and extended to cover all financial assets. The nature of asset-backed securities transactions and the reasons such opinions are rendered in connection with them, however, make such extension inappropriate. Unlike many other financial assets for which the Proposal would require an opinion, rated asset-backed securities transactions typically (i) are complex, (ii) contain unique features, (iii) require "continuing involvement" by the transferor in *several* capacities, (iv) involve large dollar values (frequently in excess of $100,000,000) and are exceptional transactions for the parties and (v) require extensive use of outside counsel. The practice of receiving "true sale" and "non-consolidation" legal opinions in such transactions arose from the rating agencies' requirement that the effectiveness of the transfer -- and the inability of third parties to disrupt the transferee's activities, even temporarily -- be demonstrated to a virtual certainty, a standard that is in excess of the "reasonable assurance" required by SFAS 125. It should be noted that not all rating agencies require unqualified legal opinions of the type required by the Proposal.

In contrast with asset-backed securities, for many of the financial assets covered by SFAS 125, such as repurchase agreements, securities loans, swaps and loan participations, there is no

tradition of attorneys rendering legal opinions with respect to insolvency issues or with respect to any other aspect of the transaction. In most cases, no attorneys are involved whatsoever. Additionally, such transactions are often done repeatedly, pursuant to standard-form documents. Obtaining written legal opinions at all in such transactions would be extremely costly, time-consuming and burdensome.

Auditors' Use of Legal Advice

Another issue addressed by the Proposal is whether limitations on use contained in legal advice would render such advice unacceptable as evidential matter. Paragraph 1.15 of the Proposal states that legal opinions containing provisions restricting their use to the law firm's client or to third parties other than the auditor are unacceptable as audit evidence. Such statements are universal features of legal opinions and are designed limit the number of parties who, in the event the opinion proved to be incorrect, may be entitled to assert claims against the rendering law firm. We believe that it should be sufficient for a legal specialist to acknowledge that the legal specialist's client (the company being audited) may show a copy of the legal opinion (or other form of legal advice) to its auditors for the purpose of the auditors' evaluation of the firm's assertions in its financial statements. We do not believe, however, that the legal specialist should be required to allow the auditors to "rely" on the legal advice.

Conclusion

We believe that legal advice in forms other than a "would" legal opinion should be deemed to be acceptable evidential matter to provide "reasonable assurance" that the isolation standard of SFAS 125 has been met. Such legal advice should be permitted to take the form of not only legal opinions not meeting the technical standards of the Proposal, but also memoranda of law and oral legal advice. What should be determinative is that the legal advice conclude that it is probable or more likely than not that the isolation standard has been met.

Many transactions that "result in [] continuing involvement by the transferor" are nonetheless "routine" in the sense that transactions involving the same fact pattern relevant to the "isolation" standard have been engaged in repeatedly in the past. In such cases, prior legal advice, whether in the form of a legal opinion, a memorandum of law or oral legal advice, should be permitted to be relied upon. In those areas where recognized industry groups have solicited legal advice with respect to classes of transactions (for instance, transactions governed by the group's standard-form documents), such legal advice should be permitted to be relied upon for factually similar transactions. In addition, assuming such legal advice clearly identified the factual elements underlying the advice, a non-lawyer should be able to evaluate whether a new transaction possessed factual elements matching those for which the advice was given, since the existence of such elements is primarily a factual, and not a legal, question.

We believe that the foregoing practices are consistent with the "reasonable assurance" standard of SFAS 125 and would lead to increased accuracy and consistency in accounting in a cost-

effective manner. Such practices would not permit transactions that are more appropriately characterized as secured borrowings to be characterized as sales. Rather, such practices would help eliminate situations in which the characterization of a transaction depended not upon economic and legal realities but upon whether the technical requirements of an artificially high evidential standard could be met. While simplifying the auditors' task by establishing a "bright-line" standard may be an understandable objective in some circumstances, we believe that inaccuracy and inconsistency are too high a price to pay for such simplification.

* * *

Should you have any questions or comments regarding this letter, please feel free to contact me at (212) 250-9241, or Joseph C. Kopec, Esq., Vice President & Counsel, at (212) 250-4925.

Sincerely,

Mark S. Leiman
Managing Director

cc: Richard H. Daniel
Mary M. Marr
Melvin A. Yellin, Esq.
Lanny A. Schwartz, Esq.
Salvatore P. Palazzolo, Esq.
Joseph C. Kopec. Esq.

Thomas D. Wren
Senior Executive Vice President
Treasurer

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MBNA America Bank, N.A.
Wilmington, Delaware 19884-0783

December 15, 1997

Julie Anne Dilley
Technical Manager, Audit and Attest Standards
File 2605
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

RE: Proposed Auditing Interpretation under Statement of Financial Accounting Standards Number 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

Dear Ms. Dilley:

MBNA America Bank, N.A. ("MBNA"), a national bank and the principal subsidiary of MBNA Corporation, appreciates the opportunity to comment on the November 24, 1997 Draft of the AU Section 9336 ("the Proposal") which was proposed by the Audit Issues Task Force ("AITF") of the Auditing Standards Board. MBNA is a major bank credit card lender and has total assets of approximately $18.5 billion and total managed loans of $45.7 billion as of September 30, 1997.

The Proposal is intended to provide guidance concerning the use and sufficiency of legal advice as audit evidence to support an assertion that a transfer of financial assets meets the isolation criterion of Paragraph 9(a) of Statement of Financial Accounting Standards Number 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* ("SFAS No. 125"). In addition, the Proposal provides guidance as to the wording of legal opinions that would support sale treatment.

The letter which accompanied the Proposal states that the AITF has initiated discussions with the Financial Accounting Standards Board ("FASB") and representatives of the Federal Deposit Insurance Corporation ("FDIC") regarding guidance contained in Paragraphs 58 and 121 of SFAS No. 125. These paragraphs address securitization structures utilized by banks subject to FDIC receivership, as well as securitization structures for other companies not subject to the U.S. Bankruptcy Code. The letter states

that guidance based on these discussions will be included in the final Interpretation, implying that there will be no comment period for the guidance which relates to entities not subject to the U.S. Bankruptcy Code but which are subject to FDIC receivership.

MBNA appreciates the AITF's effort to standardize and more clearly define the audit evidence required to support sale treatment of an asset securitization. In addition, MBNA recognizes that AITF Interpretations are not customarily released for public comment. However, MBNA strongly believes that, because guidance for entities subject to the U.S. Bankruptcy Code was released for public comment, guidance addressing banks subject to FDIC receivership should receive similar treatment prior to being included in a final Interpretation. Banks subject to FDIC receivership are major participants in the asset backed securities market and should be permitted to comment on any proposal which would impact the accounting for such a significant aspect of the banking industry's operations.

Regarding the Proposal, MBNA has the following comments.

First, paragraph 23 of SFAS No. 125 requires "reasonable assurance" that transferred assets are beyond the reach of the transferor's creditors, even in the event of bankruptcy or insolvency of the transferor. MBNA believes that a legal opinion stating that a transfer of assets would **either** be treated as a sale **or** as a perfected security interest provides reasonable assurance that the assets are beyond the reach of the transferor, even in bankruptcy or insolvency (an "either/or" opinion). MBNA believes that the AITF's proposed requirement of a "would" opinion exceeds the reasonable assurance standard of SFAS No. 125.

Second, the requirement for a legal opinion for asset securitization transactions conflicts with other current accounting and auditing guidance, such as Financial Accounting Standards Board Interpretation Number 39, *Offsetting of Amounts Related to Certain Contracts (FIN 39)*. FIN 39 does not specifically require a particular level or type of audit evidence to support the implied legal assertion; rather it leaves the question of sufficiency of audit evidence to the auditor's judgment, which is a less restrictive approach than the proposed AITF Interpretation. Therefore, this Proposal would create inconsistency within current accounting and auditing literature.

Third, a specific wording requirement for a bankruptcy legal opinion could impact the ability of multinational entities to securitize outside the U.S. market. Specifically, the Proposal's suggested wording may not be consistent with legal opinions in foreign countries due to differences in bankruptcy law and therefore could limit the ability of foreign subsidiaries of U.S. corporations to securitize loans and other financial assets.

Fourth, we wanted to comment on the last sentence of Paragraph 1.15 of the Proposal, particularly the wording "use the opinion". Paragraph 1.15 indicates that legal opinions

that restrict the use of such opinions by the auditors are not acceptable audit evidence. The Proposal suggests, however, that a restricted opinion would be sufficient if the client receives the legal specialist's written permission for the auditor to **use the opinion** (emphasis added). We believe that is it unclear whether the word **"use"** should be construed to mean review (i.e., review the opinion) or to mean rely on (i.e., rely on the opinion). Accordingly, we recommend that Paragraph 1.15 be revised to state, "for the auditor to **review** the opinion" as we believe that the auditor's review of the restricted opinion should be sufficient evidence to gain reasonable assurance of isolation.

Finally, MBNA believes that the implementation date of January 1, 1998 does not allow enough time for issuers to address the more stringent requirements included in the proposal. For example, an issuer who is planning to securitize financial assets in January 1998 will have little time to evaluate the impact of the Proposal on the transaction and to make any required changes.

MBNA strongly urges the AITF to reconsider releasing guidance related to the outcome of the AITF's discussions with the FASB and the FDIC for comment by entities subject to FDIC receivership. In addition, we urge you to consider the comments above in your draft. If you have any questions on any of these items, please contact me or Victor P. Manning, Senior Executive Vice President and Chief Accounting Officer at (302) 453-6707.

Sincerely,

Thomas D. Wren
Senior Executive Vice President and
Treasurer

(11)

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December 15, 1997

Ms. Julie Anne Dilley
Technical Manager
Audit and Attest Standards
File 2605
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Dilley:

On behalf of our members, the American Bankers Association (ABA) appreciates the opportunity to submit comments on the working draft of a proposed auditing interpretation, "The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion that a Transfer of Financial Assets Qualifies As a Sale," of Statement on Auditing Standards No. 73, Using the Work of a Specialist (working draft). This proposed auditing interpretation of the AICPA's Audit Issues Task Force (AITF) of the Auditing Standards Board (ASB) was available for comment on November 24, 1997 with responses due by December 15, 1997. The American Bankers Association brings together all categories of banking institutions to best represent the interests of the rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

We are concerned that elements of the working draft misinterpret paragraph 9(a) of FASB Statement No. 125: Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SFAS 125). The threshold for evidence to support the assertion that transferred assets have been isolated from the transferor and its creditors in the working draft is much higher than stated in SFAS 125 and is also much higher than is currently demanded by participants in the marketplace for certain transfers of assets. For example, the proposed threshold for evidence to support sale treatment in the working draft would go beyond what is currently provided for asset sales, such as loan participations, and asset securitizations by entities subject to receivership laws other than the U.S. Bankruptcy Code. We believe that unless changes and clarifications are made,

the working draft has the potential to significantly increase legal costs and to eliminate sale accounting treatment for transactions that fully meet the requirements of SFAS 125.

Paragraph 9(a) is one of four criteria that must be met in order to account for a transfer of assets as a sale under SFAS 125. Paragraph 9(a) requires that a transferor demonstrate that transferred assets are isolated from the transferor. The required level of evidence is that the transferor show that transferred assets are "presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership" (emphasis added). Further guidance on the type of evidence required to apply paragraph 9(a) is contained in paragraph 23 of SFAS 125. Paragraph 23 states that all *available evidence* be considered and that the *available evidence* needs to provide "reasonable assurance" that the transferred assets would be beyond the reach of a bankruptcy trustee or other receiver for the transferor (emphasis added).

The FASB developed this threshold for evidence to address the concerns raised by constituents during the deliberations on SFAS 125 about the feasibility of a sale criterion strictly based on legal considerations. Paragraph 119 of the basis for conclusions in SFAS 125 states that "the Board concluded that having to consider only the *evidence available* should make that requirement workable" (emphasis added). However, the following paragraphs describe elements of the working draft that are at odds with SFAS 125 and would unreasonably raise the level of evidence needed to substantiate sale treatment.

- Paragraph .12:

The example of "persuasive evidence" to support management's assertion that transferred assets are beyond the reach of the transferor and its creditors goes beyond what is currently being provided by attorneys. It is our understanding that it may be difficult for attorneys to opine, as proposed, that certain types of transactions "would be considered to be a sale...and not a loan" (emphasis added) and that "a court would not grant an order consolidating the assets and liabilities of the Purchaser with those of the Seller in a case involving insolvency of the Seller" (emphasis added). Attorneys use alternative phrasing that, in the context of the overall legal analysis, provides reasonable assurance that the transferred assets have been sufficiently isolated. It is not clear why auditors need to require a higher level of evidence than is required by SFAS 125 and the marketplace.

- Paragraph .13:

The examples in the working draft of "inadequate opinions" that do not provide "persuasive evidence" also go beyond what is currently being provided by attorneys on asset transfers by entities that are not subject to the U.S. Bankruptcy Code. First, the

examples imply that anything less than a "would" opinion would not suffice as adequate evidence. As stated in our comments on paragraph .12, it is our understanding that it may be difficult for attorneys to provide this opinion. Second, footnote 5 could render opinions used by entities that are not subject to the U.S. Bankruptcy Code inadequate. Footnote 5 states that, under limited circumstances, the following opinion would be adequate: "In our opinion, the transfer would either be a sale or..." We recommend that the AITF clarify under what circumstances this opinion would be acceptable and then issue the guidance for public comment. Third, the working draft would prohibit entities from using memorandum of law opinions for multiple transactions that are similar in nature. The evidence required by paragraph .13 unjustifiably goes beyond SFAS 125.

- Paragraph .15:

The proposed restriction on the usage of legal opinions by auditors in the working draft is a narrow interpretation of SFAS 125 that would unnecessarily raise legal costs. The working draft proposes that auditors should request the legal specialist's written permission to use legal opinions, rather than relying on the legal opinions that are provided to entities transferring assets or to third parties other than auditors. We believe that reviewing the opinions of the legal specialists should be sufficient to help auditors evaluate whether transferred assets have been isolated from the transferor.

- Paragraph .17:

The guidance in the working draft goes beyond the requirements of SFAS 125 by stating that a legal opinion is the only form of persuasive evidence of a transfer of assets. There are other forms of evidence, such as policy statements from federal agencies, that should also be considered in determining whether transferred assets have been isolated beyond the reach of the transferor and its creditors.

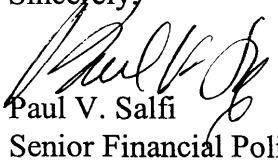
- Paragraph .18:

The AITF has proposed an overly ambitious timetable to implement the guidance in this working draft. First, if implemented as proposed, the working draft would require attorneys to make significant changes to legal opinions. The marketplace needs time to evaluate the changes in the working draft and incorporate the changes into asset transfer transactions. Second, the AITF needs to clarify the language in the working draft regarding what types of legal opinions would be acceptable for transferors that are not subject to the U.S. Bankruptcy Code. For these reasons, it would be prudent for the AITF to delay the effective date one year and apply the guidance to transactions that occur after January 1, 1999.

* * * * *

We are concerned that the result of the proposed interpretation will be to require a significantly higher threshold be met in order for certain transfers to recognized as sales, effectively amending SFAS 125. We encourage the AITF not to issue the proposal in its current form without providing additional opportunity for discussions with industry. We would be glad to work with you as you proceed to finalize the auditing guidance.

Sincerely,



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December 15, 1997

Ms. Julie Anne Dilley
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Re: File 2605, *The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion that a Transfer of Financial Assets Qualifies As a Sale.*

Dear Ms. Dilley:

We appreciate the opportunity to comment on the above-mentioned proposal. While we understand the AITF's desire to provide guidance to auditors regarding the evidence required to attain "reasonable assurance," we are greatly concerned about the requirements that this interpretation would impose on financial statement preparers, and believe that it will have a negative impact on our ability and our clients' ability to effect transactions. In addition, we believe that if a "would" level of legal opinion is required for SFAS 125 transactions, the balance sheets of many companies will not reflect true economic reality, but rather will reflect positions that are the result of remote legal uncertainty.

In particular, we believe that the proposed auditing interpretation imposes a requirement for a level of legal assurance that:

- is overly restrictive in its requirements for "would" level opinions;
- is inconsistent with, and goes well beyond, the established interpretation of "reasonable assurance";
- is in direct contradiction with the FASB's previous decision to drop the requirement for a legal opinion from the final version of SFAS 125, and is inconsistent with the stated intent of SFAS 125;
- does not take into account available evidence other than legal opinions; and
- will impose burdensome costs on financial statement preparers.

Accordingly, we ask that you seriously reconsider this proposal.

Each of the above points is discussed in more detail below.

"Would" opinions often cannot be rendered by law firms due to lack of relevant case law and/or differing standards among firms

Law firms are often unable to render a "would" level opinion for a sale transaction, due to differing standards among law firms regarding the requirements for a "would" level opinion, conflicting authority in different jurisdictions, or lack of authority and precedent. The situation can be especially acute in foreign jurisdictions, where the law on matters such as securitization may be even less well developed than US law.

It should be noted that the distinction between "should" and "would" opinions is very unclear. As noted in the *Special Report by the Tribar Opinion Committee: Opinions in the Bankruptcy Context: Rating Agency, Structured Financing and Chapter 11 Transactions*:[1]

> Many lawyers are uncomfortable with this distinction [between should and would] because they believe that a lawyer can only opine as to what a court should do when applying the applicable law to the relevant facts. Accordingly, some lawyers, when required to give a "would" opinion, have stated in the opinion letter that, in giving such an opinion, they are doing so on the understanding that the opinions expressed are not a prediction as to what a court would actually hold but an opinion as to the decision a court would reach if the issue were properly presented to it and the court followed existing legal precedents applicable to the subject matter of the opinion.
>
> **The [Tribar] Committee has found no case law or published secondary authority for the proposition that a stronger opinion is being expressed by the use of the word "would," in the context of a legal opinion, as opposed to the word "should."** (emphasis added)

We suggest that the AITF be less formulaic in terms of the legal opinion requirements and instead allow judgment to be rendered by management, with advice of legal counsel (internal and external) and the auditors, in order to accommodate situations in which a particular legal opinion standard can not be met. If a "would" opinion requirement is imposed for SFAS 125 transactions, the balance sheets of many companies will not reflect true economic reality, but rather will reflect positions that are the result of remote legal uncertainty.

If the AITF decides to adopt a set standard for legal opinions, we would encourage the AITF to accept the following types of opinions as satisfying the

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[1] 46 Bus. Law. 717 (February 1991)

"reasonable assurance" standard:

⇒ "We are of the view that a court would..."
⇒ "There is a reasonable basis to conclude that..."
⇒ "In our opinion, the transfer should be considered a sale..."
⇒ "In our opinion, the transfer would likely be..."

In addition, the assumptions and qualifiers to any particular opinion should be analyzed by parties familiar with the transaction at the time such opinion is rendered. No specific set of qualifiers should be mandated as acceptable or unacceptable, but such review should be made in accordance with the facts and circumstances of any particular transaction. Opinions rendered from non-U.S. jurisdictions should be considered under the legal opinion practices in the applicable jurisdiction.

Legal opinions not required for FIN 39; new requirement goes well beyond "reasonable assurance"

We further bring to your attention the fact that if a "would" standard is adopted for legal opinions, this would be inconsistent with the approach taken with respect to the concept of "reasonable assurance" under EITF D-43 as the standard required for the netting of assets and liabilities pursuant to FIN 39. EITF D-43 states that "Offsetting is appropriate only if the available evidence, both positive and negative, indicated that there is reasonable assurance that the right of setoff would be upheld in bankruptcy." Formal legal opinions written by outside legal counsel (whether "would" or "should" opinions) have not been necessarily required by auditors to meet the FIN 39 standard; instead, memoranda from internal legal counsel or other legal diligence have been accepted by auditors as sufficient evidence to meet the FIN 39 standard. We believe that there are substantial similarities between FIN 39 and SFAS 125, in that both standards look to the legal treatment of the transaction as a fundamental basis for the accounting treatment. As a result, we believe that there is a strong argument for applying the standard of reasonable assurance to SFAS 125 transactions in the same way as it is currently applied to FIN 39 transactions.

Requirement for true sale opinion dropped from SFAS 125

We further note that the requirement to obtain "would" level legal assurance represents a notable departure from the FASB's previous decision to drop such a requirement from the draft of the standard. While the Exposure Draft of the standard contained the requirement that the transaction be deemed a "true sale at law," the Board agreed to substitute this specialized legal phrase with the

economic concept of being "beyond the reach of the transferor or its creditors"; and although it included language stating that *positive assurance* is required in determining that assets are "beyond the reach of the transferor," we believe that the Board made it clear during its deliberations that *it would not require legal opinions* for transferors to be able to make that assertion. In particular, paragraph 19 of SFAS 125 states that "Because legal isolation of transferred assets has substance, the Board decided that it could and should serve as an important part of the basis for determining whether a sale should be recognized. Some constituents expressed concern about the feasibility of an accounting standard based on those legal considerations, but the Board concluded that having to consider *only the evidence available* should make that requirement workable."(emphasis added) This is consistent with the decision in EITF D-43, which expressly recognized that "the nature of support required for an assertion in financial statements that a right of setoff is enforceable at law is subject to a cost-benefit constraint and depends on facts and circumstances."

Requirement to obtain a legal opinion imposes an undue economic burden
The decision to reintroduce the requirement for a legal opinion also imposes costly requirements on financial statement preparers. Where legal opinions are typically already required, such as in rated securitization transactions, obtaining an opinion from legal counsel would not be a problem; but for other transactions, where opinions are not typically required (and there are many such cases), the requirement imposes an undue economic burden on financial statement preparers. It should be possible for management and auditors to use their judgment on the need to obtain a written legal opinion, particularly in situations in which oral assurance can be obtained that the relevant law applying to a particular transaction has not changed.

Other evidence exists and should be considered
We especially take issue with paragraph 17 of the proposed auditing interpretation, which states that "since the isolation aspect of surrender of control is assessed primarily from a legal perspective, the auditor usually will not be able to obtain persuasive evidence in a form other than a legal opinion." We do not believe that a legal opinion is the only evidence that should be considered when reaching a conclusion whether a surrender of control over transferred assets has been achieved. Other factors to consider are (a) pronouncements and advice by regulators as to the likely treatment of transactions in the event of bankruptcy or insolvency (such as letters published and discussions with SIPC or the FDIC); (b) market practice and long-standing views in the marketplace that

JPMorgan

particular transactions are viewed as sales; and (c) the remoteness of the occurrence of a particular event (such as consolidation of a broker-dealer with an affiliate upon bankruptcy, *even though there may not be enough developed law to support a legal opinion*).

* * *

Finally, given the potential impact of guidance in this area, we also request and strongly encourage the AITF to expose for comment the forthcoming guidance relating to banks subject to FDIC receivership. We believe that the exposure of draft standards for comment is a critical element of due process in the standard-setting process, and encourage the AITF to continue to adhere to this procedure.

I would be pleased to discuss the above comments with you further at your convenience.

Sincerely,

David H Sidwell

David Sidwell

cc: Mr. Edmund Jenkins, Chairman, Financial Accounting Standards Board

FINANCIAL EXECUTIVES
INSTITUTE

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Susan M. Koski-Grafer
Vice-President - Professional Development
and Technical Activities

December 15, 1997

Ms. Julie Anne Dilley
Technical Manager
Audit and Attest Standards
File 2605
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Subject: Proposed Auditing Interpretation: *The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion that a Transfer of Financial Assets Qualifies As a Sale*

Dear Ms. Dilley:

The Committee on Corporate Reporting (CCR) of the Financial Executives Institute is pleased to comment on the AICPA's Proposed Auditing Interpretation, *The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion that a Transfer of Financial Assets Qualifies As a Sale.* The Financial Executives Institute is an organization of senior corporate financial executives. Its more than 14,000 members are the chief financial officers, vice presidents of finance, controllers and treasurers of over 8,000 U.S. and Canadian organizations reflecting the diversity of the business landscape, including nearly all of the 1,000 largest corporations in North America as well as a broad spectrum of smaller and privately held companies.

While CCR obviously does not object to the AICPA issuing audit guidance, we are very concerned that in this instance the proposed audit guidance would have the effect of changing the accounting requirements of Statement of Financial Accounting Standards No. 125 ("FAS 125") without due process.

Specifically, we believe that the auditing interpretation would have the effect of modifying the accounting standard contained in FAS 125 by (i) requiring that formal legal opinions be obtained for a significant number of transactions and (ii) requiring a standard higher than "reasonable assurance" that the transferred assets have been isolated from the transferor. In either case, a transaction which fully met the sale accounting

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criteria in FAS 125 but did not meet the guidance in the proposed audit interpretation criteria would lead to one of two undesirable outcomes -- a qualified or adverse audit opinion if the transaction was accounted for as a sale, or potentially misleading financial statements if it was accounted for as a financing. CCR believes that certain provisions of the proposed interpretation must be revised in order to avoid such adverse consequences. The balance of this letter describes the basis for CCR's views along with our recommendations for revising the draft interpretation.

Background

One of the criteria for recognizing a transfer of financial assets as a sale under FAS 125, which became effective on January 1, 1997, is that "the transferred assets have been isolated from the transferor - put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership."

CCR and many other parties objected to this approach when they responded to the FASB's exposure draft which led to the issuance of FAS 125. CCR's comment letter to the FASB stated:

> "We do not believe that the "bankruptcy" test is necessary or appropriate. There is no similar test for other significant types of assets transfers (such as sales of inventory, fixed assets, real estate or business divestitures). Further, a bankruptcy test runs counter to the going-concern assumption in accounting, and could result in a company reporting an asset on its balance sheet over which it lacks legal/economic ownership and control, and reporting a liability that it does not owe and will not repay. Exceptions to the going concern assumption have implications far beyond asset transfers, and are already covered by existing accounting and reporting guidelines."
>
> "As the Exposure Draft itself notes, constituents (including representatives of the legal profession) have expressed misgivings about relying on current legal concepts of bankruptcy in this area. In addition, from a cost/benefit perspective, the rating agencies, investors, and providers of credit enhancement generally appear satisfied that the "bankruptcy" opinions suggested in the FASB proposal [for example, true sale at law opinions] are not necessary and do not add value to their assessment of these transactions."

Despite the concerns raised in the comment letters, FAS 125 retained the bankruptcy requirement. However, paragraph 23 of FAS 125 indicates that the nature and extent of supporting evidence required for an assertion in the financial statements that the transferred financial assets have been isolated beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership, depends on the facts and circumstances. All available evidence that either supports or questions an assertion must be considered. Sale accounting treatment is appropriate "only if the available evidence

provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver [emphasis added]."

Proposed Audit Requirement for Legal Opinions

Paragraph 17 of the proposed auditing interpretation states that "since the isolation aspect of surrender of control is assessed primarily from a legal perspective, the auditor usually will not be able to obtain persuasive evidence in a form other than a legal opinion." The result of this guidance will be to require legal opinions to be obtained for audit purposes which are clearly not required for business purposes or for accounting purposes under FAS 125.

The FASB deliberated this issue extensively before reaching their conclusion in FAS 125 that consideration be given to all available evidence. FAS 125 does not require that legal opinions be obtained solely for accounting purposes. The basis for conclusions in FAS 125 contains the following discussion of this decision [emphasis added]:

> 118. ...Credit rating agencies and investors in securitized assets pay close attention to (a) the possibility of bankruptcy or other receivership of the transferor, its affiliates, or the special-purpose entity, even though that possibility may seem unlikely given the present credit standing of the transferor, and (b) what might happen in such a receivership, because those are major areas of risk for them...Credit rating agencies and investors commonly demand transaction structures that minimize those possibilities and sometimes seek assurances from attorneys about whether entities can be forced into receivership, what the powers of a receiver might be, and whether the transaction structure would withstand receivers' attempts to reach the securitized assets in ways that would harm investors...
>
> 119. Because legal isolation of transferred assets has substance, the Board decided that it could and should serve as an important part of the basis for determining whether a sale should be recognized. Some constituents expressed concern about the feasibility of an accounting standard based on those legal considerations, but the Board concluded that having to consider only the evidence available should make that requirement workable.

The proposed audit guidance requiring that legal opinions be obtained solely for auditing purposes runs counter to the FASB's accounting conclusion. In fact, the underlined comment in paragraph 119 above suggests that the FASB had previously concluded that the AICPA's current proposal would be unworkable. CCR believes that the AICPA should avoid imposing an audit requirement that goes beyond the accounting requirements of FAS 125. Our specific recommendation is that the second sentence of

paragraph 17 in the proposed audit interpretation be eliminated, in order to conform the audit guidance with the accounting standard.

Proposed Guidance on Persuasive Evidence

Paragraph 13 of the proposed interpretation states that "a legal letter that includes conclusions that are expressed using some of the following language would not provide persuasive evidence," and goes on to provide a series of 11 sentence fragments that might appear in a legal letter. Under the proposed interpretation, the presence of any of these sentence fragments would cause the auditor to reject the adequacy of the letter.

CCR does not believe that the proposed guidance is appropriate, because it would cause the auditor to reject a legal letter containing certain phrases even if the letter in its totality provides the reasonable assurance required by FAS 125. In effect, the proposed interpretation replaces the FAS 125 requirement for reasonable assurance with an audit standard requiring virtual certainty.

In CCR's view, it is essential that judgment be applied in determining whether a legal letter provides persuasive evidence and reasonable assurance. The legal profession itself emphasizes the importance of considering the overall legal analysis. For example, the Legal Opinion Accord of the Section of Business Law of the American Bar Association (1991) discusses an "explained opinion" as follows:

> "An explained opinion (often referred to as a "reasoned opinion") expresses not only a legal conclusion but also provides or summarizes the legal analysis supporting that conclusion. Explained opinions often deal with issues involving legal uncertainties due to the nature of the process (e.g., bankruptcy), conflicting authority or perhaps lack of authority. While an explained opinion may also reach a qualified or unqualified conclusion, the ultimate professional judgment cannot, in either case, be fairly separated from the totality of the opinion provided."

A similar view is expressed in the Business Law Monograph, "Legal Opinions in Corporate Transactions" by Arthur Field and Read Ryan of Shearman & Sterling (1992). CCR notes that the proposed audit interpretation indicates that legal letters containing the word "would" provide persuasive evidence, while opinions using the word "should" do not. Field and Ryan make the following observation:

> "Sometimes the recipient will want the word "would" used. There is no difference in meaning whether the word "would" or "should" is used. One judges the force of a reasoned opinion by the authorities cited and the reasoning in it, and not by labels."

CCR believes that the auditing guidance should be consistent with the reasonable assurance requirement of FAS 125, and should not require virtual certainty. Sentence

fragments should not be considered in isolation, but instead need to be evaluated in the context of the legal letter as a whole. CCR therefore recommends that the audit interpretation be revised to replace the listing of sentence fragments with an emphasis on the need for professional judgment in evaluating the overall legal analysis.

However, if the AICPA believes that specific examples of wording need to be provided in the auditing interpretation, CCR recommends that the guidance be revised to indicate that the following sentence fragments -- which the current draft states are problematic from an audit perspective -- would be compatible with persuasive evidence if supported by the overall legal analysis:

- "We are of the view...
- "There is a reasonable basis to conclude that..."
- "In our opinion, the transfer should be considered a sale..."
- "In our opinion, the transfer would presumptively be..."
- "In our opinion, it is probable that..."
- "In our opinion, the transfer would either be a sale or a perfected security interest..."

****

As noted above, CCR's overall concerns are with the portions of the draft audit interpretation that would have the effect of modifying the accounting standards contained in FAS 125. If, after considering these concerns, the AICPA decides to proceed with the audit guidance as currently drafted, we believe that due process is needed comparable to that which would be provided if the FASB were amending FAS 125.

We would be pleased to discuss our comments further at your convenience. This response was developed on behalf of CCR by Fred Battline of Citicorp, a member of CCR's Financial Instruments and Hedging Subcommittee. Should you have any questions, please contact him at (212) 559-7721.

Sincerely,

Susan Koski-Grafer
VP-Professional Development &
Technical Activities

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December 15, 1997

VIA FACSIMILE [(212) 596-6091] AND U.S. MAIL

Auditing Standards Board
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Attention: Julie Ann Dilley
Technical Manager,
Audit and Attest Standards,
File 2605

Re: "Proposed Auditing Interpretation, The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion that a Transfer of Financial Assets Qualifies As a Sale." of Statement on Auditing Standards No. 73, Using the Work of a Specialist ("Proposed Interpretation").

Dear Ladies and Gentlemen:

On behalf of the Committee on Law and Accounting, with participation of the Committee on Business Bankruptcy and the Subcommittee on Structured Financings of the Section of Business Law of the American Bar Association, we are writing to comment on the above described proposed interpretation. All references to paragraph numbers apply to the paragraphs so numbered in the Proposed Interpretation.

The comments herein have been prepared by a Task Force composed of members of the Committee on Law and Accounting. However, these comments do not represent the official position of the American Bar Association, the Section of Business Law or of the Committees or Subcommittee named above.

We note preliminarily that the Proposed Interpretation deals with the verification of an assertion by an entity in its financial statements that transferred financial assets have been put presumptively beyond the reach of the transferor and its creditors. We also note that the determination of the accuracy of such assertion may be largely a matter of law. Accordingly, the auditor may be required in many cases to use a legal opinion as evidential matter in assessing the accuracy of such assertion.

1. **The "persuasive evidence" standard:**

The language of SFAS 125, and in particular ¶ 23, requires that "the available evidence provide *reasonable assurance* that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver..." [emphasis ours]. However, the Proposed Interpretation requires, in effect, that the opinion of the legal specialist provide "*persuasive evidence* to support management's assertion that a transfer of financial assets meets the isolation criterion of SFAS 125." [¶ 1.02, emphasis ours]

This standard of persuasive evidence is not contained in, or in our view justified by, the requirements of SFAS 125. Nor, to the best of our knowledge, is it required by the "sufficient evidential matter" field work standard of GAAS.

In our view, this is a central flaw in the Proposed Interpretation section, leading to a series of inappropriate conclusions, including limits on the language of an acceptable attorney's opinion (¶ 1.13), limits on the use of an opinion restricted to stated third parties (¶¶ 1.15, 1.16), and excessive--if not exclusive--reliance on the opinion as the sole audit evidence (¶ 1.16).

2. **Limits on the permissible language of the attorney's opinion:**

The draft contains a laundry list of forbidden clauses, any of which would apparently prevent an opinion from constituting "persuasive evidence." Our objections to the "persuasive evidence" standard are indicated above. Independently, however, this list is in our view inappropriate.

In the first instance, an opinion of an attorney should represent a component of the evidential matter collected in the audit, irrespective of its language. The language should go not to whether the opinion is evidential matter, but rather to its weight.

Secondly, several of the forbidden clauses in ¶ 1.13 (e.g., those speaking of "presumptively" "probable," and "either or") should, in appropriate circumstances, be an entirely satisfactory basis for the conclusion required by SFAS 125.

An important, and troublesome, implication of the draft (amplified by its refusal to recognize certain opinions with restrictions) is that the opinion must be drafted in language that is acceptable *to the auditor*, as well as (or possibly instead of) the client. This insistence that the evidential matter itself be created in a form satisfactory to the auditor has no apparent justification in the language of SFAS 125 or in the usual GAAS standards of field work.

3. **Prohibition on the use as evidence of restricted opinions:**

The draft explicitly states that "an auditor should not use as evidence" an otherwise adequate opinion if the opinion letter restricts the use of its findings to the client or other third parties. (¶ 1.15) This, in our view, represents a fundamental misconception of the concept of "evidential matter." Whether the opinion is restricted or not, it constitutes evidential matter. This, it appears to us, is an attempt on the part of the auditor to require a direct representation by the attorney to readers of the financial statements, rather than an attempt to verify--by appropriate audit evidence--the reasonableness of management's representation.

There are a number of major problems with this new, and to our knowledge unique, requirement. Most importantly, it places the attorney giving counsel on a transaction in the position of advising the world at large, in a liability-assuming letter. The auditor is required to determine only whether the client is justified in relying on the opinion. Secondly, it creates potentially an issue with respect to the initial drafting of the opinion, which by implication must be written with the audit in mind. The typical opinion is restricted to the addressee, the client. The client can, of course, show it to the auditor, but the lawyer is not opining to the auditor.

4. **Exclusive, or near-exclusive, reliance on legal opinion as evidential matter:**

In ¶ 1.17, the draft--though permitting the possibility of other evidence--states that "the auditor usually will not be able to obtain persuasive evidence in a form other than a legal opinion." Combined with the other elements of the draft, this clause creates, in our view, the real possibility of an untenable position for counsel to a transaction. And, while the draft argues that the "isolation aspect of surrender of control is assessed primarily from a legal perspective," it does not make a reasonable argument supporting its ultimate conclusion: that the auditor must have an opinion from the attorney to the auditor, in the prescribed language, giving direct assurance of isolation.

We appreciate your giving us the opportunity to comment on the Proposed Interpretation. We should appreciate an opportunity to meet with you in person to help clarify our comments and aid in any drafting improvements to meet our concerns.

Very truly yours

Daniel Goldwasser per AS

Daniel Goldwasser, Chair,
Committee on Law and Accounting

Abraham M. Stanger
Task Force Chair

AMS:eun

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Francis T. McGettigan
Deputy Comptroller
*Tel: (203) 373-2863 / 8*229-2863*
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Corporate Accounting Operation
3135 Easton Turnpike, W3J, Fairfield, CT 06431

Monday, December 15, 1997

Ms. Julie Dilley
Technical Manager
Audit and Attest Standards
American Institute of CPAs
1211 Avenue of the Americas
New York, NY 10036-8775

Re: File Reference 2605

Dear Ms. Dilley:

General Electric Company is responding to the AICPA Proposed Interpretation, *The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion that a Transfer of Financial Assets Qualifies as a Sale*.

We object, as a matter of principle, to this proposed interpretation. We believe that it is inappropriate for the Auditing Standards Board to propose interpretive guidance that is fundamentally an amendment to the authoritative accounting literature (in this case, Statement of Financial Accounting Standards (SFAS) No. 125). We view this proposed action as setting a disturbing precedent for other potential audit concerns that result from unclear or judgmental aspects of generally accepted accounting principles.

We therefore recommend that this issue be referred to the FASB for possible issuance of an Interpretation or Technical Bulletin that would amend SFAS No. 125. We perceive two important benefits to this approach:

- A change of this magnitude should be effected by an amendment to the related FASB Statement; that is where preparers of financial statements will expect to find it and its absence will risk that many will be unaware of the interpretive position taken.
- The proposed change should be subject to the same robust due process that was associated with the original Statement. The basis for conclusions of SFAS No. 125 acknowledges the difficulties associated with the isolation criteria and the Board's view that focusing the requirements on "available evidence" would make the standard "workable". We believe that effectively mandating that auditors obtain a legal opinion on the isolation criterion, and further specifying that only certain language in that letter would be acceptable, modifies what constitutes available evidence. Such a significant modification makes it imperative that the Board revisit the issues of practicability and costs associated with a higher standard of assurance, a task that, for obvious reasons, is clearly inappropriate for the ASB to consider.

Finally, on the technical merits of the ASB's conclusions, we have serious reservations on the basis that they present financial statement preparers with a major potential dilemma. Transactions that fully meet SFAS No. 125 criteria but not those of the proposed interpretation must result in one of two equally untenable outcomes - a qualified or adverse audit opinion if sale accounting is used, or financial statements that do not reflect the proper economics or accounting for the deal if treated as a financing. We believe that the FASB must resolve this issue.

I should be pleased to discuss any questions you may have regarding these comments.

Sincerely,

Francis T. McGettigan

Francis T. McGettigan

FTM:sbc

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CHEVY CHASE BANK

Chevy Chase Bank
8401 Connecticut Avenue
Chevy Chase, Maryland 20815

December 16, 1997

Ms. Julie Ann Dilley
Technical Manager
Audit and Attest Standards
File 2605
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Dilley:

Chevy Chase Bank is a $6 billion financial institution headquartered in the Washington, D.C. area and an active securitizer of consumer loan receivables. We are pleased that the AICPA has formed a task force to develop implementation guidance for SFAS No. 125, however, we are concerned that the current draft of that guidance does not adequately address certain issues. We are also concerned about the treatment of "single-step" securitizations by banks subject to FDIC receivership. The purpose of this letter is to primarily discuss "real life" implementation issues faced by banks with respect to paragraph 9(a) of SFAS No. 125.

It is most unfortunate that SFAS No. 125 contains guidance on what constitutes acceptable evidence to support an assertion that "assets have been isolated from the transferor." Moreover, the guidance in paragraph 23 has placed auditors in the unenviable position of asking attorneys whether or not a transaction should be accounted for as a sale. Attorneys provide their opinions regarding the isolation of assets, but to ask them whether a sale has occurred for accounting purposes is backwards.

Securitization transactions are highly structured. Rating agencies, investment bankers, credit enhancers and trustees review these transactions to ensure that the structure is sound and that the interests of public investors are adequately protected. In the case of private transaction, investors hire their own counsel to review the structure. If assets are not properly isolated from the transferor or not put presumptively beyond the reach of its creditors, then the structure won't work, rating agencies won't rate, enhancers won't enhance, and trustees won't accept the trust. The assurance in these matters comes from opinions of counsel delivered at the time of the transaction which are based on law, facts and circumstances. In light of the structure requirements, an additional opinion of counsel seems superfluous. Prior to the implementation of SFAS No. 125, the attorneys relied on the accountants regarding sale treatment, now it is the other way around.

Moreover, we do not believe that attorneys will render an opinion that a transfer "would" be a sale for structures typically used by banks. It seems that the task force has recognized this problem. Paragraph 13 lists examples of language which are inconsistent with sale treatment. The last bullet, "In our opinion, the transfer would either be a sale or..." is footnoted with the statement that "under limited circumstances, this [language] may be acceptable for a transferor that is not subject to the U. S. Bankruptcy Code." However,

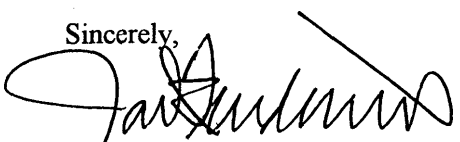
the draft interpretation provides no guidance regarding those limited circumstances. We encourage the task force and the AICPA to consider what those circumstances should be, to discuss them with appropriate constituents, and to expose them for comment prior to issuing this guidance.

Lastly, we are uncertain of the direction of the discussions regarding "single-step" transfers by banks. As a result, we are concerned with the statement that the "Task Force plans to include guidance based on the outcome of those discussions in the final interpretation" without exposing for comment a draft of that guidance. Most banks securitize loans using a "single-step" structure. A requirement to use a "two-step" structure would be devastating to both the banking and securitization industries. Because SFAS No. 125 applies to current transfers of assets within existing transactions (the so called "revolving period"), such a requirement would affect ongoing transfers of assets within existing trusts, impose unnecessary burdens in connection with future transactions and effectively nullify previous sale accounting for all outstanding transactions that are in their revolving period.

In summary, we are very concerned that the FASB has effectively required banks to demand additional sale opinions from their attorneys to determine whether a transaction should or should not be treated as a sale for accounting purposes. In structured transactions, attorneys have in the past, and will likely continue to render opinions regarding whether assets subject to a transaction have been isolated from the transferor and put presumptively beyond the reach of the transferor and its creditors at the time of the transaction. Such opinions currently satisfy the requirements of all parties to securitization transactions and, as drafted, also satisfy the letter of paragraph 9(a) of SFAS No. 125.

Should you have any questions or comments regarding these matters, please feel free to contact me at (301) 986-6864.

Sincerely,



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Price Waterhouse LLP

December 15, 1997

Ms. Julie Anne Dilley
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1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Dilley:

We appreciate the opportunity to comment on the proposed auditing interpretation, *The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Qualifies as a Sale* (the "Interpretation").

The legal aspects of transactions has always impacted accounting and audit matters. Statement of Financial Accounting Standards No. 125 (SFAS 125), *Accounting for Transfers and Servicing of Financial Assets and Exstinguishments of Liabilities*, has caused auditors to become even more focused on legal structure when evaluating transfers of financial instruments. Unfortunately, this heightened awareness and the requirements of SFAS 125 have resulted in practice diversity on what audit evidence is necessary to support management's assertion that a financial asset sale has occurred. Generally, that audit evidence debate has centered on the need for and content of legal letters.

The Interpretation resolves several aspects of the legal letter controversy and we support the guidance therein. Equally important, however, is that the SFAS 125 Audit Issues Task Force (the "Task Force") continue its work, as indicated in your cover letter, and pursue timely resolution of the audit evidence issues related to transactions of institutions subject to FDIC receivership. In addition, we have the following comments on specific paragraphs of the Interpretation:

1. Paragraph .07: We believe that an auditor should test management's assertion that the new structure is the same as the prior one before evaluating the need for an update of the legal letter issued for the prior structure.

2. Paragraphs .16-.17: Our suggestion is to split this question and interpretation into two questions with separate interpretations. The first question should address the lack of persuasive evidence in a legal letter and the second question should focus on when the legal specialist does not grant permission for the auditor to use a legal opinion. When presented together as one question, the interpretation seems less clear.

We look forward to working with the Task Force in the future and would be pleased to discuss our comments with you.

Sincerely,

Price Waterhouse LLP

(18)

Securities Industry Association

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December 16, 1997

Julie Anne Dilley
Technical Manager
Audit and Attest Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
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Re: November 24, 1997 Draft of Proposed AU Section 9336; File No. 2605

Dear Ms. Dilley:

Thank you for giving the Capital Committee of the Securities Industry Association ("SIA")[1] the opportunity to respond to the above-referenced working draft of a proposed audit interpretation of Statement on Auditing Standards No. 73, Using the Work of a Specialist ("Draft Interpretation"). We understand that the Draft Interpretation is being considered by the FASB 125 Audit Issues Task Force ("Task Force") of the Audit Standards Board ("ASB"). The intended purpose of the draft is to provide guidance regarding the use of a legal specialist's finding as audit evidence to support Management's assertion that a transfer of financial assets meets the legal isolation criterion of paragraph 9(a) of Statement of Financial Accounting Standards ("SFAS") No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." The Committee takes great interest in SFAS 125 and other accounting pronouncements inasmuch as the basis for most regulatory computations is data prepared under generally accepted accounting principles.

We believe that, in its current form, the Draft Interpretation requires a level of legal assurance that is likely to be, as a practical matter, unattainable or extremely difficult to obtain in many instances. This strictness, in turn, will deter many commonplace securities transactions that have long been treated as sales. In addition, we

[1] The Securities Industry Association brings together the shared interests of more than 770 securities firms throughout North America to accomplish common goals. SIA members -- including investment banks, broker-dealers, and mutual fund companies -- are active in all markets and in all phases of corporate and public finance. In the U.S. SIA members collectively account for approximately 90 percent, or $100 billion, of securities firms' revenues and employ about 350,000 individuals. They manage the accounts of more than 50-million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans. More information about SIA is available at our Internet web site, http://www.sia.com.

believe that, as currently written, the Draft Interpretation is inconsistent with certain of the key provisions of SFAS 125.[2]

I. Specific Concerns With the Draft Interpretation.

The Draft Interpretation Sets an Impracticably High Standard for Legal Comfort and Would Significantly Hinder Well-Established Types of Securities Transactions. The Draft Interpretation effectively requires that in order to book any "non-routine" transaction as a sale under paragraph 9(a) of SFAS 125, management must obtain an opinion letter of counsel stating the lawyer's belief that the transfer "would be considered to be a sale" under the U.S. Bankruptcy Code. Counsel advises us that there is little case law with respect to the bankruptcy status of transactions covered by SFAS 125 upon which a lawyer could base a "would" opinion.[3] Moreover, for many types of transactions, different lawyers may come to different legal conclusions as to whether a "would" standard is satisfied. A less severe standard, more in line with current practice (whether a "more likely than not" standard or some similar articulation), would increase the likelihood that firms will account for similar transactions in a consistent manner.

The draft states that "the auditor usually will not be able to obtain persuasive evidence in a form other than a legal opinion" and that "conclusions about hypothetical transactions may not be relevant to the transaction that is the subject of management's assertions. . . ." We question this view in two respects. First, we believe that there may be occasions when other facts, such as regulatory approval or guidance, can be sufficient to demonstrate that the isolation criteria have been met.

Second, the practical effect of this view would be to require an opinion letter for a vast number of transactions, such as securitizations, for which they have not been required until now. We believe that auditors should not be required to obtain a legal opinion for every transaction. Rather, in many instances, it should be sufficient for auditors to require that a determination has been made that a particular transaction fits within the assumptions made in a prior opinion or legal memorandum.[4] Auditors should

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[2] SIA's concern about the serious adverse effect that the Draft Interpretation could have on the securities markets is widely held. In spite of the fact that the Draft Interpretation was only circulated just prior to Thanksgiving, allowing only 12 business days for the industry to respond, SIA has been advised that a number of securities firms and at least one other trade association plan to respond. This high response rate to an interpretation that the ASB itself acknowledges has relatively remote authority is highly indicative of widely held concerns about the business implications of the interpretation.

[3] We understand that the Bond Market Association plans to discuss extensively the current trends in the case law in this area. To avoid redundancy, we refer you to that letter for more information on this point.

[4] Such a determination would not necessarily have to be made by a lawyer, so long as the person making the determination is able to give the auditors comfort that the transaction is encompassed within the assumptions made in a prior opinion letter or legal memorandum.

have the same latitude under SFAS 125 that they have in applying other accounting standards, such as FIN 39, to make judgments as to what evidence is required to support an audit determination.

The Committee believes that the effect of requiring "would" opinions would be to discourage or curtail many structured transactions. The reason for this is two-fold. First, because of the impracticality of obtaining such a high level of legal comfort, broker-dealers would be forced to carry transactions on their books that otherwise would be on their books only under very remote circumstances (*i.e.*, a bankruptcy of the broker-dealer coupled with the failure of a legal comfort letter). The "would" approach poses even greater concerns for non-U.S. affiliates of U.S. financial institutions. We understand that there is currently varying practice with respect to providing "would" opinions in many foreign jurisdictions. The failure of non-U.S. lawyers to accommodate the terms of the interpretation draft would be yet another impediment that the Draft interpretation would pose to many transactions.

Second, in many instances in which transactions are still undertaken, there will be undue legal and regulatory consequences. For example, in some situations there could be a significant possibility that a broker dealer would be compelled to record a sale on its balance sheet, while a counter-party broker-dealer would also record the same assets on its balance sheet.[5] As a result of this double-counting, both sides of transactions may be required to take capital charges on the same assets, potentially diminishing broker-dealers' ability or desire to provide market liquidity. Consequently, as currently drafted, the Draft Interpretation would create unnecessary and undesirable obstacles to transactions that are integral to the modern securities markets.[6]

The Draft Interpretation Is Inconsistent With Standards Set Out in SFAS 125. While the exact nature of evidentiary matter that can satisfy Paragraph 9(a) is not entirely clear, the Committee believes that SFAS 125 does not require that legal comfort must come in the form of a legal opinion, and, to our knowledge, the FASB has not put forward such a restrictive requirement. The relevant provisions of SFAS 125 suggest that no particular form of legal comfort is required in all situations. Paragraph 9(a) requires that "the transferred assets have been isolated from the transferor – put *presumptively*

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[5] For example, for certain types of sales, (*e.g.*, structured transactions) bankruptcy case law is scarce or non-existent. Since a "would" opinion in such areas is likely to be unobtainable, the selling broker-dealer and the receiving broker-dealer might both have to carry assets on their books.

[6] For example, a "would" opinion might be impossible to obtain for an asset sale coupled with a total return swap, because there currently is no bankruptcy case law on this type of transaction. However, if this compels sellers to carry such assets on their balance sheets, it becomes more probable that if a bankruptcy involving such assets ever does occur, a court might conclude from the fact that the asset remained on the seller's balance sheet that there was not an intent to sell.

beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership" (emphasis added). Paragraph 23 states that the evidence needed to support a determination that financial assets have been isolated in this manner depends on the facts and circumstances. Paragraph 23 concludes with the statement that "derecognition of transferred assets is appropriate only if the available evidence provides *reasonable assurance* that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates . . . ." (emphasis added).[7]

In contrast, paragraphs .12 and .13 of the Draft Interpretation suggest that the form of legal assurance must be the highest possible assurance – that the transfer of financial assets "would be" considered a sale, and therefore not deemed to be property of the seller's estate in bankruptcy, or "would not" result in a court order consolidating the assets and liabilities of the purchaser with those of the seller. Paragraph .13 specifically rejects less strict formulations of opinion language, such as "reasonable possibility," "reasonable basis to conclude." "should," "more likely than not," "would presumptively be," and "it is probable that." [8]

The Committee believes that the emphasis in these provisions of the Draft Interpretation on the need for a "would" opinion is much more inflexible than is suggested by the italicized words from SFAS 125 set out above. We believe SFAS 125 contemplates a number of levels of possible formulations of the strength of the legal opinion that must be obtained to satisfy paragraph 9(a). Paragraph 9(a) uses the word "presumptively". Similarly, paragraph 23 uses the terms "would likely" and "reasonable assurances that assets would," and Paragraph 118 refers to assurances acceptable to rating agencies, which do not typically require "would" opinions.

The Draft Interpretation is Inconsistent With Audit Practice Regarding Similar Accounting Standards. In other circumstances involving the accounting treatment for significant financial transactions, FASB pronouncements have not been understood to require a "would" opinion from counsel. In particular, SFAS 5, SFAS 109, FIN 39 and FIN 41 are, like SFAS 125, FASB pronouncements (some of them quite recent) that address the legal comfort that is appropriate for accounting treatment.

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[7] Paragraph 118 is the only provision of SFAS 125 that suggests that any particular form of legal assurance is required. That paragraph only states that the FASB developed its criteria for Paragraph 9(a) "in large part" with reference to rated securitization practices, and that "credit rating agencies and investors . . . *sometimes* seek assurances from attorneys" (emphasis added) about the bankruptcy status of special purpose vehicles and securitized assets.

[8] Paragraph .12 of the Draft Interpretation assumes that "persuasive evidence" is the standard that supporting evidence of isolation must satisfy. We respectfully suggest that Paragraph 23 of SFAS 125 strongly suggests that the appropriate standard is "reasonable assurance."

However, we understand that none of these pronouncements require a "would" opinion.[9] It is difficult to see why a higher standard of reasonable assurance should be taken in connection with isolation of assets under SFAS 125 than, for example, under FIN 39.[10]

II. Suggested Changes to Draft Interpretation.

Consistent with our comments above, we believe that the following changes would address some of our concerns:

.05, second sentence. Change to "use of a legal specialist often [strike usually] is necessary."

.12, first sentence. Strike "persuasive evidence" and replace with "reasonable assurance."

.12, first and second indented paragraph. Strike italicized "would" and replace with "should."

.13. Strike "persuasive evidence" in first and second sentences and replace with "reasonable assurance."

.13. In the list of sample phrases that would not provide reasonable assurance, strike the third, fourth, sixth, eighth, ninth and tenth bulleted phrases.

.13. Strike footnote 6.

.16. Strike "persuasive evidence" and replace with "reasonable assurance."

.17. In the second sentence, strike " the auditor usually will not be able to obtain persuasive evidence" and replace with "often will not be able to obtain reasonable assurance." In the third sentence strike "persuasive evidence" and replace with "reasonable assurance."

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[9] Our understanding is that under these pronouncements, legal comfort (whether an opinion letter of other legal memoranda) providing a "more likely than not" assurance has been widely accepted as sufficient.

[10] FIN 39 states that "[o]ffsetting is appropriate only if the available evidence, both positive and negative, indicates that there is a reasonable assurance that the right of setoff would be upheld in bankruptcy." It would be difficult to construe this language as generally mandating a "would" opinion of counsel.

Conclusion.

Again, the Committee very much appreciates the opportunity to comment on the Draft Interpretation. If you have questions about this letter or we can be of further assistance, please contact the undersigned at 212-902-1360 (or via e-mail at mark.holloway@gs.com), or contact the Committee's staff adviser, George Kramer, at 202-296-9410 or at gkramer@sia.com.

Sincerely,

Mark W. Holloway /s/ GKramer

Mark W. Holloway
Chairman
SIA Capital Committee

cc: Michael H. Sutton, SEC Chief Accountant
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Michael Helmick, President, SIA Financial Management Division
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